S. HRG. 99-886

S. 2647, A BILL TO CREATE A PRIVATELY OWNED, FEDERALLY CHARTERED CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 2647

A BILL TO CREATE A PRIVATELY OWNED, FEDERALLY CHARTERED CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

AUGUST 7, 1986

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S. 2647, A BILL TO CREATE A PRIVATELY OWNED, FEDERALLY CHARTERED CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

THURSDAY, AUGUST 7, 1986

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 428A, Russell Senate Office Building, Hon. Lowell Weicker, Jr. (chairman of the committee) presiding.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, COMMITTEE ON SMALL BUSINESS

The CHAIRMAN. The Senate Small Business Committee will come to order.

Today, it is holding a hearing on S. 2647, legislation which Senator Bumpers and I introduced on July 16 to create a privately owned federally chartered corporation, known as the Corporation for Small Business Investment, or COSBI.

Specifically, COSBI would operate as a capital bank to finance SBIC and MESBIC programs and would handle the licensing and regulation of these investment companies.

Since first being authorized by the Small Business Investment Act of 1958, the SBIC industry has been a vital source of long-term capital for small businesses. And during that time, SBIC's and MESBIC's have invested over $6 billion in more than 70,000 growing small businesses.

Among its more notable success stories are companies like Federal Express, Apple Computer, Cray Research, and Essence magazine.

The industry has a track record of which it can be proud.

I recognize that the SBIC and MESBIC industries have spent a considerable amount of energy and resources in moving this legislation to this point, and I understand clearly that they view the enactment of S. 2647 as essential to the continuation of their industry, particularly given the administration's current attitudes.

In the last 2 years, the administration has proposed the outright elimination of the SBA, and this program in particular, despite its unquestioned success. And even though this will make a meaningful step in the direction of privatization—letting the private capital markets provide funding for the SBIC's and MESBIC's--the administration has announced that unless COSBI represents a total abandonment of any Federal involvement or support, it will oppose the legislation.

In 1958, Congress recognized that many small growing firms were simply unable to obtain equity financing or long-term capital. To address this credit gap, it created the SBIC Program—a classic public/private partnership committed to fostering the entrepreneurial spirit in America.

It would be wrong to suggest that the Federal Government can walk away from this program and assume the private sector will do the job. S. 2647 seeks to reduce the Federal role and encourages greater private sector involvement. However, the partnership still will be maintained in order to ensure that the objective of the 1958 act is realized.

Late yesterday, I received a letter from OMB Director Miller, setting forth the administration's views basically in opposition to all Government-sponsored enterprises. And according to that letter and the testimony we will receive later today from the SBA, it appears that a COSBI proposal in any form would be unacceptable to the administration.

The proposal before the committee today is identical to a major rewrite of the COSBI proposal introduced in the House by Congressman Parren Mitchell and other members of the House Small Business Committee on June 12, 1986. On July 23, 1986, the House committee reported out this bill with amendments and has included it as their recommendations in the Omnibus Reconciliation Act of 1986.

Today's hearing will look more closely at the role of the SBA and the Federal Government in overseeing the activities of COSBI. And in that regard, we will hear from the SBA Inspector General Mary Wieseman, whose office currently has responsibility for auditing and investigating SBIC's, as well as Bob Turnbull, representing the SBA and the administration.

Another major issue of today's hearing is whether COSBI can hope to sell its securities in the market if it is required to purchase the current SBIC portfolio without recourse to the Federal Government.

To advise us on these issues, we have representatives from Wall Street, Miner Warner of Salomon Bros., and Mike Clare, of Citicorp. And, of course, to explain key aspects of the proposal, we have Tom Noojin, of NASBIC, and Herb Wilkins, of AAMESBIC.

Now, let me say this: that I am not much inclined, time constraints being what they are, to academic exercises. I am 100 percent behind the COSBI concept, and I think that there is a very good chance that not only will the bill be reported out, but that possibly something can be devised between the House and the Senate as to getting it through the legislative branch of Government, but I have got to contend, not just with the opposition to COSBI, but I have got an administration that is still rather weak on its commitment to the Small Business Administration, period, and without a great amount of grassroots support, I don't see this idea going anywhere.

I have got more fights than any man could possibly deal with in this town, and I am perfectly willing to take this one on, but it is not going to be done alone. So, I want to point out at this stage of the game, I would say the odds look very slim as to having this concept go into law.

I am not saying very slim in getting out of the committee; it will get out of the committee. And, as I said, it will probably even get out of the Congress, but what I look forward to is not spending 2 hours of time on something that is going nowhere.

So, I want to advise all the witnesses that are here in support of this idea, those that are visitors in support of this concept, which I think is a good concept, that their words are far better directed at this junction toward the executive branch of government, and hopefully the small business community and its spokesmen have a greater entree to, and a greater impact on, the President of the United States than does the chairman of the Small Business Committee.

So, with those admonitions, and wishing you well in your task, I will turn to the one that I have at hand, and our first panel includes Mr. Robert Turnbull, Associate Deputy Administrator for Management and Administration, Small Business Administration, Mr. Turnbull being one of those representing the administration that did his best to see that there was no administration for him to be associate deputy administrator of——

[Laughter.]

The **Chairman** [continuing]. And Ms. Wieseman, the Inspector General of the Small Business Administration.

Mr. Turnbull.

ROBERT A. TURNBULL, ASSOCIATE DEPUTY ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION, SMALL BUSINESS ADMINISTRATION

Mr. **Turnbull**. Thank you, Mr. Chairman.

It is a pleasure to be here before you today. I want to thank you for inviting us to testify on S. 2647, the COSBI Charter Act.

I have with me today, sitting behind me, Ed Holloway, our Associate Administrator for Finance and Investment, and Bob Lineberry, our Deputy Associate Administrator for Investment.

Mr. Chairman, this is the fourth in a series of bills introduced since 1984 in the Senate and the House of Representatives that would create a corporate instrumentality of the United States for the purpose of converting the SBIC Program to a private sector activity. This conversion has been characterized as privatization, which, as you said upon introducing the bill, is now in vogue.

As you further remarked, upon introducing the bill, this bill is identical to H.R. 5019, which was introduced on June 12, 1986, by Representative Parren Mitchell, chairman of the House Small Business Committee.

The identity between S. 2647 and H.R. 5019 compels us to have the same substantive comments on, and objections to, the bills. Therefore, with your permission, I would like to submit for the record SBA's testimony of June 24, 1986, on H.R. 5019.

The **Chairman**. It will be so included.

Mr. TURNBULL. Thank you.

[The prepared statement of SBA's testimony of June 24, 1986, follows:]

SBA

U.S. Small Business Administration
Washington, DC 20416

STATEMENT OF

ROBERT A. TURNBULL
ASSOCIATE DEPUTY ADMINISTRATOR
FOR
MANAGEMENT AND ADMINISTRATION
SMALL BUSINESS ADMINISTRATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

JUNE 24, 1986

MR. CHAIRMAN, THANK YOU FOR INVITING SBA TO APPEAR AND TESTIFY ON H.R. 5019, WHICH, IF PASSED BY THE CONGRESS AND APPROVED BY THE PRESIDENT, WOULD CREATE THE CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI).

THIS BILL INTENDS TO CREATE COSBI TO PROVIDE A NEW METHOD OF FINANCING AND REGULATING THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM.

THIS BILL IS THE THIRD VERSION IN TWO YEARS OF COSBI LEGISLATIVE PROPOSALS. THE FIRST WAS INTRODUCED IN THE SENATE AS S. 2686 ON MAY 17, 1984, AND THE SECOND WAS INTRODUCED IN THE HOUSE OF REPRESENTATIVES AS H.R. 3484 ON OCTOBER 2, 1985. SBA WAS ASKED BY SENATOR WEICKER TO COMMENT ON THE TWO PREVIOUS VERSIONS AND DID SO ON DECEMBER 11, 1984, AND JANUARY 21, 1986, RESPECTIVELY. SBA SUPPLIED A COPY OF ITS JANUARY 21, 1986, COMMENTS TO THIS COMMITTEE.

AT THIS TIME, IF THERE IS NO OBJECTION, I WOULD LIKE TO SUBMIT COPIES OF THOSE TWO SBA LETTERS FOR THE RECORD.

WHILE SBA FULLY SUPPORTS THE CONCEPT AND PRINCIPLE OF TRULY PRIVATIZING THE SBIC PROGRAM, WE MUST OPPOSE THIS BILL BECAUSE IT DOES NOT ADDRESS OR CURE THE MAJOR OBJECTIONS WHICH LED TO OUR OPPOSITION OF THE TWO PREVIOUS VERSIONS. IN FACT, IT CONTINUES, WITH ENHANCEMENTS, KEY ELEMENTS OF FEDERAL FINANCIAL SUPPORT

WHILE GREATLY WEAKENING GOVERNMENT FINANCIAL AND REGULATORY OVERSIGHT. THE BILL, IN OUR OPINION, DOES NOT MEET THE OBJECTIVE OF REPLACING FEDERAL FINANCIAL ASSISTANCE OF SBICs WITH PRIVATE FINANCIAL SUPPORT. THIS TESTIMONY WILL BE LIMITED TO COMMENTS ON THE MAJOR POLICY ISSUES AND DOES NOT REPRESENT A SECTION BY SECTION DISCUSSION.

THE PROPOSED NEW SECTION 354(c) AUTHORIZES THE SECRETARY OF THE TREASURY, IF PROVIDED FOR IN ADVANCE BY AN APPROPRIATIONS ACT, TO PURCHASE UP TO $500 MILLION OF COSBI OBLIGATIONS FOR THE PURPOSE OF SUPPORTING THE CONTINUING FUNDING OF SBICs. IT IS OUR VIEW THAT THIS OPEN-ENDED BACKSTOP LINE OF CREDIT IS NOT CONSISTENT WITH THE PRINCIPLES OF PRIVATIZATION AND IS UNACCEPTABLE.

THE BILL WOULD PROVIDE, IN SECTION 361, FOR SALE OF APPROXIMATELY $1 BILLION OF SBA-GUARANTEED SBIC DEBENTURES BY THE U.S. TREASURY TO COSBI AT THEIR OUTSTANDING BALANCES (PAR). THE SBA GUARANTEE WOULD CONTINUE ON THESE DEBENTURES RISKING SIGNIFICANT FEDERAL OUTLAYS FOR YEARS TO COME WITHOUT PROVIDING FOR ADEQUATE FINANCIAL CONSIDERATION FOR THIS RISK. THESE DEBENTURES, AT THE

PRESENT TIME, HAVE MARKET VALUE IN EXCESS OF PAR AND, BASED UPON PRESENT INTEREST RATES, SUCH A SALE AT PAR RATHER THAN MARKET VALUE WOULD PROVIDE A SUBSTANTIAL WINDFALL TO COSBI AT THE EXPENSE OF THE U.S. TREASURY. THAT WINDFALL TODAY IS ESTIMATED TO BE AS HIGH AS $150 MILLION. IN THE ABSENCE OF THAT WINDFALL, THE NECESSITY OF SUCH A CASH SALE TO THE FORMATION OF COSBI MUST BE QUESTIONED.

IN ADDITION TO THE BORROWING POWER FROM THE TREASURY, THE WINDFALL FROM THE PURCHASE OF DEBENTURES FROM THE TREASURY AT LESS THAN THEIR MARKET VALUE, AND THE CONTINUING OF THE FULL FAITH AND CREDIT GUARANTEE OF SBA ON THE DEBENTURES, THE BILL PROVIDES, IN SECTION 361, FOR A $100 MILLION CASH GRANT TO A SPECIAL-PURCHASE TRUST TO BE OPERATED BY COSBI FOR THE BENEFIT OF SECTION 301(D) LICENSEES (MESBICs). ALSO, IN SECTION 359, THE BILL PROVIDES FOR THE GRANT AND CONVEYANCE TO THE SPECIAL-PURPOSE COSBI TRUST, FOR NO CONSIDERATION, OF $255 MILLION OF AGENCY ASSETS. THESE ASSETS ARE THE OUTSTANDING PREFERRED STOCK AND DEBENTURES OF MESBICs, ACCUMULATED IN THE MESBIC PROGRAM UP TO THIS TIME. THE TRUST BENEFICIARIES WOULD BE MESBIC PROGRAM PARTICIPANTS AND A MAJORITY OF THE TRUSTEES WOULD BE MESBIC REPRESENTATIVES.

THE COMBINATION OF THE WINDFALL TO COSBI FROM ITS PURCHASE OF SBA GUARANTEED DEBENTURES, THE CASH GRANT, AND THE CONVEYANCE OF SBA ASSETS, WOULD REPRESENT FEDERAL SEED CAPITAL FOR COSBI OF APPROXIMATELY $500 MILLION. THIS, OF COURSE, WOULD BE IN ADDITION TO THE GOVERNMENT'S CONTINUING TIMELY PAYMENT GUARANTEE ON ASSETS PURCHASED BY COSBI, AND THE CONTINGENT TREASURY AUTHORITY TO PURCHASE COSBI OBLIGATIONS.

THE BILL, IN SECTION 353, REQUIRES EACH SMALL BUSINESS INVESTMENT COMPANY QUALIFYING FOR COSBI TO PURCHASE, IN AN AMOUNT UP TO 2 PERCENT OF ITS PRIVATE CAPITAL, THE COMMON STOCK OF COSBI. THIS WOULD REPRESENT AN INITITAL INVESTMENT BY THE SBIC INDUSTRY OF ONLY ABOUT $25 MILLION, IF ALL SBICs AND MESBICs CHOSE TO QUALIFY.

THE FEDERAL GOVERNMENT'S CONTINUING FINANCIAL RISK, IN THE FORM OF GUARANTEES ON THE PURCHASED DEBENTURES AND THE FUTURE BORROWINGS FROM THE TREASURY, COUPLED WITH THE SEED CAPITAL IN THE FORM OF GRANTS AND PURCHASE PRICE CONCESSIONS ON THE SBIC DEBENTURES, WOULD BE SUBSTANTIALLY GREATER THAN THE LICENSEES' $25 MILLION AND IT IS FOR THAT REASON THAT THIS BILL IN OUR OPINION WOULD NOT ACCOMPLISH ITS INTENDED OBJECTIVES.

THE EFFECT OF THESE PROVISIONS OF THE BILL IS MAINLY TO SUPPLEMENT EXISTING FEDERAL SUPPORT OF THESE PROGRAMS WITH UP-FRONT CONCESSIONS AND GRANTS, AND FUTURE BORROWING POWER FROM THE U.S. TREASURY, IN CASE THESE CONCESSIONS AND GRANTS PROVE INSUFFICIENT OR SHOULD COSBI EXPERIENCE OPERATING DIFFICULTIES.

IN LIGHT OF THIS SUBSTANTIAL FEDERAL FINANCIAL SUPPORT, THE BILL DOES NOT, IN OUR OPINION, PROVIDE FOR THE PROPER BREADTH AND DEPTH OF DIRECT FEDERAL MANAGEMENT, CONTROL, OR OVERSIGHT. IT DOES NOT PROVIDE FOR DIRECT REGULATORY AUTHORITY OVER SBICs AND MESBICs BY SBA's INSPECTOR GENERAL, ENFORCEMENT POWERS TO SBA, NOR THE DIRECT EXECUTIVE BRANCH REGULATORY AUTHORITY AND ENFORCEMENT POWERS OVER THE OPERATIONS OF COSBI. WE BELIEVE THAT SUCH AN IMBALANCE BETWEEN THE GOVERNMENT'S FINANCIAL RISK AND REGULATORY AUTHORITY IS NOT IN THE GOVERNMENT'S BEST INTERESTS AND PROVIDES LITTLE INCENTIVE FOR SOUND PRIVATE SECTOR ADMINISTRATION OF COSBI.

THERE ALSO IS A BASIC ISSUE OF FAIRNESS TO THOSE SBICs THAT HAVE NEVER USED SBA FUNDS WHICH SHOULD BE CONSIDERED. THERE ARE ABOUT

185 OF THESE SBIC's WITH $425 MILLION OF PRIVATE CAPITAL. SECTION 322 WOULD REQUIRE REVOCATION OF THESE SBIC's LICENSES WITHIN TWO YEARS OF THE DATE THAT COSBI WAS OPERATIONAL UNLESS THESE SBICs QUALIFY FOR COSBI BY PAYING 2% OF THEIR PRIVATE CAPITAL TO COSBI FOR THE PRIVILEGE OF CONTINUING TO DO WHAT MANY OF THEM HAVE BEEN DOING FOR MORE THAN TWENTY YEARS. THIS REQUIREMENT IS PARTICULARLY OBJECTIONABLE AS IT IS UNFAIR TO THOSE SBICs THAT HAVE SERVED THE OBJECTIVES OF THE PROGRAM WELL WITHOUT DIRECT OR GUARANTEED FEDERAL FINANCIAL ASSISTANCE.

IN SUMMARY, IT IS OUR BELIEF THAT THIS BILL DOES NOT PRIVATIZE THESE PROGRAMS IN A FINANCIAL SENSE AND, THUS, ITS ELEMENTS THAT PRIVATIZE THE REGULATION OF SBICs ARE INAPPROPRIATE. ACCORDINGLY, WE CANNOT SUPPORT IT.

THANK YOU FOR GIVING US THIS OPPORTUNITY TO TESTIFY ON THIS BILL.

21 1986

Honorable Lowell Weicker, Jr.
Chairman
Committee on Small Business
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This replies to your letter of December 16, 1985, requesting the views of the Small Business Administration on a bill, H.R. 3484 which proposes to create a capital bank for small business investment companies.

H.R. 3484 dated October 2, 1985, which would create a Corporation for Small Business Investment (COSBI), is similar in its stated objectives and for the most part its provisions to the bill, S.2686 dated May 17, 1984, which you introduced for yourself and Senator D'Amato.

As I indicated to you in my letter of December 11, 1984, commenting on S.2686, we are in agreement with the principle of privatizing the small business investment company program. It would appear, however, that H.R. 3484 does not meet that objective. In some respects it increases the Federal Government's financial support of the program. For example, H.R. 3484, as well as the explanatory material distributed by its proponents shows that :

> (1) pursuant to Section 15(a) there would be a $ 1.0 billion direct obligation of COSBI to the United States Treasury (with no specific due date or amortization provisions) for purchase of the SBA-Guaranteed SBIC Debentures (Debentures) presently held by the Federal Financing Bank (FFB); and,

(2) the direct obligation as in (1) above would be at an interest rate 2% per annum below the average weighted interest rate on the Debentures providing an implicit subsidy initially of some $ 20.0 million annually; and,

(3) pursuant to Section 11(c) the United States Treasury would provide contingent financial support indefinitely of $ 1.0 billion to COSBI as a backup; and,

(4) pursuant to Section 15(a) the Debentures purchased by COSBI from the FFB rather than securing the $ 1.0 billion of outstanding obligations to the United States Treasury as in (1) above, would be used to secure the borrowings of COSBI the proceeds of which would not be used to reduce the obligations to the Treasury; and,

(5) Section 301(d) SBICs (MESBICs) would continue to receive government support and a subsidy from a funded trust created pursuant to Section 8 which would receive a capital contribution from the Federal Government of some $350.0 to $ 400.0 million.

It is noted also that COSBI would have the status of an instrumentality of the United States and be exempted from some of the provisions of the tax and securities laws, see for example Section 12. Further, we are concerned for those SBICs that do not use SBA leverage and might be forced to join and financially support COSBI for no commensurate benefit other than escaping disenfranchisement.

Although this is not an exhaustive analysis of H.R. 3484, it is clear that COSBI would not be privatized in a financial sense and therefore we cannot support the bill.

Ironically, among Federal programs the SBIC Program today seems an ideal candidate for transitioning to fully private funding as envisioned by its authorizing legislation. As we have noted on other occasions, the program has developed a significant human resource in the form of its present complement of seasoned venture capital managers. The collective financial track record of the SBIC industry appears to be superb. For example, during the past five years, it has attained its highest levels of private capitalization, financings to small business concerns, and return on investment both realized and unrealized. We would hope, therefore, to have the opportunity to support legislation which resolves the shortcomings of the present bill and leads to the complete and expeditious disengagement of Federal financial assistance to SBICs.

In our letter to you dated December 11, 1984, which included our comments on your S.2686, we put forth some guiding principles for the further development of the COSBI concept. Now as then, we stand ready to discuss with you alternate provisions, or other proposals that might accomplish the objective of truly privatizing the SBIC program.

Thank you for the opportunity to provide these comments. We look forward to working with you further on this important matter.

The Office of Management and Budget advises that it has no objection to the submission of this report to the Congress.

Yours truly,

James C. Sanders

James C. Sanders
Administrator

cc: Honorable Parren J. Mitchell
Chairman
Committee on Small Business
House of Representatives

OI/JLWerner/1-20-86
cc: CLA
OGC
Mr. Turnbull
Mr. Holloway
Mr. Lineberry
Mr. Werner
OIG
Mr. Weinmann
Wang 0003w

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

DEC 11 1984

Honorable Lowell Weicker, Jr.
Chairman
Committee on Small Business
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your request for the views of the Small Business Administration on S. 2686, a bill "To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment and to transfer certain functions of the Small Business Administration to the Corporation."

SBA, although in favor of the concept of privatization of the Small Business Investment Company (SBIC) Program, would oppose the enactment of this bill.

When you introduced this legislation on May 17, 1984, you stated in part:

> "...the legislation is complex and it raises a number of policy and technical issues which should be open to public discussion and comment. Consequently, while I fully support the objective of improving the flow of venture capital to small business, I have introduced the legislation in an effort to initiate public dialog on the proposal, and it does not carry my endorsement at this time."

Our comments on the bill, therefore, are made with your statement in mind and are meant to set forth some basic principles which we feel should guide any further discussions.

Purpose of the Legislation

The purpose of the bill is to withdraw Federal Government financial support from the SBIC industry, and to replace it with a centralized purely private sector source of funds. Additionally and contemporaneously, the bill proposes to simplify and streamline the regulation of SBICs.

A government-sponsored corporation, the Corporation for Small Business Investment (COSBI), would be created and financed in the private sector that would finance and regulate SBICs. In short, an SBIC for SBICs. There would no longer be a need for SBA direct or guaranteed authorization and appropriations for those SBICs choosing to qualify and purchase stock in COSBI. MESBICs would be administered by COSBI on behalf of the Federal Government but would still require annual appropriations.

The SBA agrees that the SBIC industry should make a transition to the private sector as originally intended by Congress. Congress' intent is made clear in the Statement of Policy, Section 102 of the Small Business Investment Act of 1958, as amended, (Act) when it states that:

> "...this policy shall be carried out in such a manner as to insure the maximum participation of private financing sources."

Further, Section 308(g)(2)(A) of the Act specifically requires in SBA's Annual Report:

> "The Administration's recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies to replace Government financing of such companies." (Underline added for emphasis.)

However, this bill does not lead to privatization of SBICs; it sets up another Government supported organization. Further, under the present program structure a discernible privatization has occurred. From 1981-1984 there has been an unprecedented increase in private sector funds flowing into small business concerns through both SBICs and non-SBIC sources.

Regulation of SBICs

As long as any SBIC or MESBIC has outstanding any obligation to SBA, any obligation guaranteed by SBA, any preferred stock held by SBA, or enjoys any tax advantage as an SBIC, it should be subject to regulation by SBA.

Regulation of COSBI

During the time that COSBI has any financial obligation outstanding to the Treasury, or enjoys the contingent support of the Treasury, its operations should be regulated by the Federal Government directly, and it should be subject to periodic audits by the General Accounting Office.

Control of COSBI

It is contemplated that COSBI would be owned and controlled by SBICs once the initial $20.0 million of voting common stock is issued to SBICs and paid for. It is our opinion that voting control of COSBI should be in the Federal Government, and all the elected Directors of COSBI be elected by the Federal Government (SBA/Treasury) as long as COSBI has any obligations outstanding to Treasury, or enjoys the contingent support of the Treasury.

Assignment of Assets-Assumption of Debts

The bill provides that COSBI be assigned all SBA-guaranteed SBIC debentures now held by the FFB in consideration of its assumption of all the FFB's obligations to the Treasury related to those debentures. Section 15 of the bill which relates to this transaction should contain specific terms and conditions to that assignment and assumption to avoid any unintended misinterpretation of Congressional intent when the transaction is negotiated. Such terms and conditions should include, but not be limited to, provisions:

(1) that the obligations to Treasury of COSBI be senior to all other borrowings of COSBI; and

(2) that the obligations outstanding to Treasury be fully secured by the pledge of SBA-guaranteed SBIC debentures to which they relate; and

(3) that the voting stock of COSBI be pledged to secure the obligations of COSBI to the Treasury; and

(4) that no dividends, distributions, redemptions, or dispositions of assets may be made by COSBI without prior approval of the Federal Government (SBA/Treasury); and

(5) that the transaction be at par or face value on both sides with no implicit subsidy.

Approval of the Secretary of the Treasury

Section II of the bill provides that obligations issued by COSBI shall be issued after consultation with the Secretary of the Treasury. It is our opinion that the timing, interest rates, terms, and conditions of any COSBI issuance of securities require the approval of the Secretary of the Treasury.

Participation by SBICs in COSBI

In Section 7(e)(5), SBICs licensed and operating at the time of the enactment of the bill that elect not to qualify for COSBI and purchase the stock of COSBI will cease being SBICs. We do not think this is appropriate treatment since many SBICs have no intention of using leverage, are not hampered by the present regulatory structure, and thus do not need COSBI. Many SBICs have indicated that they do not support COSBI and that SBICs that do should pursue it on their own without effecting dissenting SBICs.

SBA Authorizations and Appropriations

The bill should be specific as to its intent with respect to Federal financial support for those SBICs that choose not to qualify, or for some reason cannot qualify for COSBI. It should make clear that SBICs choosing COSBI will no longer be refunded by SBA nor be eligible for any new SBA leverage, nor for the tax advantages presently available.

COSBI Regulation of SBICs

Section 9 of the bill relates to the contractual regulation of [illegible] by COSBI but addresses only the conflict of interest issue. In our opinion, the bill should clearly spell out all regulatory matters to be included in such contracts for the protection of small business concerns.

Treasury Authorization to Purchase COSBI Obligations

The Treasury is authorized, in section 11(c), to purchase obligations of COSBI up to $1.0 billion at the discretion of the Secretary of the Treasury. The intent of this Section should be made clear on the face of the legislation including the boundaries of the Treasury's discretion. Use of funds derived from such purchases should be limited to protecting the credit standing of COSBI, and not be used for funding or refunding SBIC obligations to COSBI.

Financial Feasibility

Even though COSBI has been compared to Fannie Mae, Sallie Mae, and Freddie Mac, and its structure made similar to those three [illegible]-government corporations, there are significant generic differences between the SBIC securities contemplated to be assets of COSBI, and the obligations making up the assets of those three organizations.

The asset quality of COSBI, absent the SBA guarantee on the SBIC securities as is contemplated by the bill, will be speculative at best while the asset quality of those other organizations is investment grade. Therefore, we do not think that the optimistic estimates that COSBI borrowings will be at AAA or better rates are valid especially after the SBA guarantees expire which at the latest will be ten years from the date of the enactment of the legislation.

Effect on Other SBA Programs

SBA is also concerned that, as drafted, this bill would, pursuant to its proposed section 3, repeal Sections 309(d) (authority to conduct hearings) and 310(a) (authority to conduct investigations) of the Act, thereby impairing the Agency's ability to investigate participants in and to conduct hearings involving the programs other than the SBIC Program covered by the Act -- i.e., the Surety Bond Program, the Pollution Control Finance Guarantee Program, and the Section 501, 502 and 503 Programs.

In summary, the issues discussed and commented upon herein are the major issues that we see at this time. Although many of the provisions of this bill are not acceptable to SBA, we are in agreement with the principle of privatizing the SBIC Program by truly privatizing the program or by satisfying our regulatory concerns.

The concept of replacing fully government-guaranteed financing of SBICs by financing techniques that would enable a meaningful and continuing participation by purely private investors has our support.

Thank you for the opportunity to comment on S. 2686 and we stand ready to discuss with you alternate provisions, or other proposals, that might make this bill acceptable, or otherwise accomplish its objectives.

The Office of Management and Budget advises that it has no objection to the submission of this report to the Congress.

Yours truly,

James C. Sanders

James C. Sanders
Administrator

Mr. TURNBULL. The concept of privatization, though attractive at this point in time, is not well defined. There is a diversity of opinion as to what it is, when it is achieved, and how it works through time.

This administration believes that privatization is the absence of Government financial and regulatory involvement in an economic activity, that it exists when the complete government withdrawal from such activity has been achieved, and that it works well, since it lets the natural forces of the marketplace efficiently allocate the nation's scarce resources.

We recognize that some public purpose activities can, and should be, privatized, and we believe that the SBIC Program is one that lends itself to privatization.

This administration's definition of privatization would be met, and it would have no objection to S. 2647, if the SBIC debentures held by the FFB were to be sold without SBA's guarantee, and if COSBI were not given the authority to borrow from the Treasury.

Further, the administration's policy on this issue requires that the FFB be paid a price equal to that at which the borrower can presently prepay under existing contracts between the SBA and the FFB.

In light of the substantial initial and continuing financial support that the bill would provide, and the fact that COSBI would exist to serve the public policy purpose of ensuring a consistent flow of private equity capital and long-term loan funds for small business concerns, it is our opinion that the COSBI Charter Act goes too far, too fast, in privatizing the Federal Government's administrative and regulatory oversight and control of the SBIC Program.

If the bill would truly withdraw Federal financial support, then SBA would see only the need for the oversight of COSBI to deal with achieving its public policy purposes.

Having summarized our overall position regarding this bill, I would like to address the areas of particular interest to this committee indicated in your letter of July 31, 1986, to Acting Administrator Heatherly.

With regard to how COSBI would work, I note that the agenda for this hearing includes testimony by members of the financial community. Since, in the long run, COSBI will live or die by its ability to sell its financial obligations and securities in sufficient amounts on competitive terms, that testimony, I hope, could shed some substantial light as to COSBI's possibilities in the credit markets.

However, we have previously indicated our concern that COSBI's underlying portfolio of small venture financings would obviously be less secure and diverse than, for example, FNMA's mortgage portfolio, a significant amount of which is government guaranteed.

Thus, the possibility that COSBI might have to call upon Treasury's contingent lending authority is much greater, and, for this reason, this bill should make it clear that such authority would only be available to protect COSBI's creditors and not to provide additional funds to SBIC's or to subsidize their borrowing costs.

Such stipulations would not only be prudent on the part of the government, but also seem to better serve COSBI's ability to obtain funds by virtue of investor reliance on government agency status.

It appears that long-term control of COSBI will be entirely in the hands of SBIC's and MESBIC's, as the bill gives them exclusive right to purchase its voting common stock. A board of directors dominated by SBIC and MESBIC personnel would presumably oversee the policy and administration, with day-to-day operating authority and responsibility residing in a paid staff serving at the pleasure of the board.

This committee certainly may wish to consider increasing the proportion of Presidentially appointed board members, at least while the Government's financial risk is disproportionate to the private sector's, and require that such directors be outside directors without ties to the SBIC industry.

However, with respect to your concern over adequate safeguards of the public interest and the continuing government exposure on the SBA-guaranteed debentures and the Treasury credit line, the most practical safeguards would be financial caveats on COSBI. Enforcement of these safeguards and other public interest needs would best be achieved by providing SBA adequate authority under this bill to audit, investigate, and seek administrative, civil and criminal remedies as may be warranted with respect to COSBI or any SBIC or MESBIC.

In addition to assuring that COSBI might borrow from the Treasury for creditor protection purposes, four other provisions should be incorporated into S. 2647.

First, new language should be added to make SBIC obligations held or guaranteed by the Government senior to any SBIC borrowings from or obligations guaranteed by COSBI.

Also, because COSBI's management of the SBIC industry will affect SBA's guaranteed creditor position, it should be at risk on the debentures it purchases that carry SBA's guarantee.

Accordingly, this bill should require that COSBI establish a funded loss reserve to reimburse the government for its loss.

In connection with the loss reserve provision, COSBI should be prohibited from making any distributions paying dividends on its voting common stock, or repurchasing any of its voting common stock until it has met its obligations, if any, under this provision.

Last, COSBI should be required to promptly furnish to SBA copies of all annual audits or other reports filed by its SBIC's which have outstanding securities held or guaranteed by SBA.

These five provisions, if incorporated in S. 2647, would provide a better incentive for capital management of COSBI during the period that the government remained at risk.

I am aware of, and in agreement with, the views of SBA's Inspector General on this proposed legislation as set forth in her letter to you of July 28, 1986. I am, therefore, limiting my remarks in the expectation that Inspector General Wieseman will advise you in some detail concerning audit, investigation, and criminal enforcement considerations, particularly as they may relate to the public policy purposes of COSBI.

I believe your comment in the Congressional Record, when you entered this bill, states that:

> Despite our hopes and expectations that COSBI will prove a financial success, there is always the risk that things won't go as anticipated. In that event, we want to be sure to establish the proper safeguards to protect the public interest in the context of assuring that the purposes of the Small Business Investment Act are being fulfilled.

This is very well taken, and we believe that if the aforementioned recommendations and those of the Inspector General are incorporated in this bill, Mr. Chairman, the adequacy of such safeguards would be significantly improved. This should not, however, be considered as this Administration's endorsement of any bill including these recommendations.

Few, if any, of these safeguards would be necessary if the bill's provisions would cancel SBA's guarantee on the SBIC debentures that would be sold to COSBI and if there was no backup line of credit from the Treasury.

In summary, it is our opinion that S. 2647 does not privatize the SBIC Program in a financial sense and that, as proposed, the bill would create a substantial imbalance between the Federal Government's financial risk and public policy programmatic risk, and its ability to oversee and manage that risk in a prudent manner in the public interest. Therefore, we cannot support it in its present form.

You, Mr. Chairman, and other past and present members of this committee have been diligent in your regulatory financial and public policy oversight of this SBIC Program. At the same time, you have been sensitive to the delicate balance that must be maintained in this program between regulation and oversight and the private sector freedom of action in pursuit of financial gain.

Your support has enabled us to preserve that delicate balance, and together we must continue to ensure that balance even in this privatization effort.

I thank you, Mr. Chairman, for your time, and I stand ready to answer any questions you may have.

[The prepared statement of Mr. Turnbull follows:]

SBA
U.S. Small Business Administration
Washington, DC 20416

STATEMENT OF
ROBERT A. TURNBULL
ASSOCIATE DEPUTY ADMINISTRATOR
FOR
MANAGEMENT AND ADMINISTRATION
SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

AUGUST 7, 1986

MR. CHAIRMAN, THANK YOU FOR YOUR INVITATION TO PROVIDE THIS COMMITTEE WITH SBA'S TESTIMONY ON S. 2647, THE CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT (COSBI ACT).

THIS IS THE FOURTH IN A SERIES OF BILLS INTRODUCED SINCE 1984 IN THE SENATE AND THE HOUSE OF REPRESENTATIVES THAT WOULD CREATE A CORPORATE INSTRUMENTALITY OF THE UNITED STATES FOR

THE PURPOSE OF CONVERTING THE SBIC PROGRAM TO A PRIVATE SECTOR ACTIVITY OUTSIDE OF THE FEDERAL GOVERNMENT STRUCTURE. THIS CONVERSION HAS BEEN CHARACTERIZED AS "PRIVATIZATION" WHICH, AS YOU SAID UPON INTRODUCING THE BILL, IS IN VOGUE NOW. AS YOU FURTHER REMARKED UPON INTRODUCING THE BILL, IT IS IDENTICAL TO A BILL, H.R. 5019, WHICH WAS INTRODUCED IN THE HOUSE ON JUNE 12TH, 1986, BY REPRESENTATIVE PARREN MITCHELL, CHAIRMAN OF THE HOUSE SMALL BUSINESS COMMITTEE. THE IDENTITY BETWEEN S. 2647, AND H.R. 5019 COMPELS US TO HAVE THE SAME SUBSTANTIVE COMMENTS ON, AND OBJECTIONS TO THE BILLS. THEREFORE, WITH YOUR PERMISSION, I WOULD LIKE TO SUBMIT FOR THE RECORD SBA'S TESTIMONY OF JUNE 24TH, 1986, ON H.R. 5019, AND TO ELABORATE ON THOSE COMMENTS AND OBJECTIONS AND TO ADDRESS SOME ISSUES THAT HAVE ARISEN SINCE THEN.

THE CONCEPT OF PRIVATIZATION, THOUGH ATTRACTIVE AT THIS POINT IN TIME, IS NOT WELL DEFINED. THERE IS A DIVERSITY OF OPINION AS TO WHAT IT IS, WHEN IT IS ACHIEVED, AND HOW IT WORKS THROUGH TIME. THIS ADMINISTRATION BELIEVES THAT PRIVATIZATION IS THE ABSENCE OF FEDERAL GOVERNMENT FINANCIAL AND REGULATORY INVOLVEMENT IN AN ECONOMIC ACTIVITY, THAT IT EXISTS WHEN THE COMPLETE GOVERNMENT WITHDRAWAL FROM SUCH ACTIVITY HAS BEEN ACHIEVED, AND THAT IT WORKS WELL SINCE IT LETS THE NATURAL

FORCES OF THE MARKETPLACE EFFICIENTLY ALLOCATE THE NATION'S SCARCE RESOURCES. WE RECOGNIZE THAT SOME PUBLIC PURPOSE ACTIVITIES CAN AND SHOULD BE PRIVATIZED, WHILE OTHERS CLEARLY MUST REMAIN WITHIN THE FEDERAL GOVERNMENT DUE TO THEIR UNIQUE NONDIVISIBLE NATURE, RISK/COST CHARACTERISTICS, OR IMPERATIVE HUMAN IMPACTS. THE SBIC PROGRAM IS ONE WHICH IN OUR VIEW LENDS ITSELF TO PRIVATIZATION AS THIS ADMINISTRATION DEFINES THAT CONCEPT.

THIS ADMINISTRATION'S DEFINITION OF PRIVATIZATION WOULD BE MET, AND IT WOULD HAVE NO OBJECTION TO S. 2647, IF THE SBIC DEBENTURES HELD BY THE FEDERAL FINANCING BANK WERE TO BE SOLD WITHOUT SBA'S GUARANTEE AND IF COSBI WAS NOT TO BE GIVEN AUTHORITY TO BORROW FROM THE TREASURY. FURTHER, THE ADMINISTRATION'S POLICY ON THIS ISSUE REQUIRES THAT THE FFB BE PAID A PRICE EQUAL TO THAT AT WHICH THE BORROWER COULD PREPAY UNDER EXISTING CONTRACTS BETWEEN THE SBA AND THE FFB.

IN LIGHT OF THE SUBSTANTIAL INITIAL AND CONTINUING FINANCIAL SUPPORT THAT THE BILL WOULD PROVIDE, AND THE FACT THAT COSBI WOULD EXIST TO SERVE THE PUBLIC POLICY OF ENSURING A CONSISTENT FLOW OF PRIVATE EQUITY CAPITAL AND LONG-TERM LOAN FUNDS FOR SMALL BUSINESS CONCERNS IT IS OUR OPINION THAT THE COSBI CHARTER ACT GOES TOO FAR TOO FAST IN PRIVATIZING THE FEDERAL GOVERNMENT'S ADMINISTRATIVE AND REGULATORY OVERSIGHT AND CONTROL OF THE SBIC PROGRAM. IF THE BILL WOULD TRULY WITHDRAW FEDERAL FINANCIAL SUPPORT, THEN SBA WOULD SEE ONLY THE NEED FOR OVERSIGHT OF COSBI TO ENSURE THAT IT WOULD ACHIEVE ITS PUBLIC

POLICY PURPOSES. THE BILL'S PRESENT PROVISIONS DO NOT EVEN PROVIDE FEDERAL GOVERNMENT OVERSIGHT TO ENSURE THAT PUBLIC POLICY IS BEING SERVED.

HAVING SUMMARIZED OUR OVERALL POSITION REGARDING THIS BILL, I WOULD LIKE TO ADDRESS AREAS OF PARTICULAR INTEREST TO COMMITTEE MEMBERS INDICATED IN YOUR LETTER OF JULY 31, 1986, TO ACTING ADMINISTRATOR HEATHERLY.

WITH REGARD TO HOW COSBI WOULD WORK, I NOTE THAT THE AGENDA FOR THIS HEARING INCLUDES TESTIMONY BY MEMBERS OF THE FINANCIAL COMMUNITY. SINCE IN THE LONG RUN COSBI WILL HAVE TO LIVE OR DIE BY ITS ABILITY TO SELL ITS FINANCIAL OBLIGATIONS AND SECURITIES IN SUFFICIENT AMOUNTS ON COMPETITIVE TERMS, THAT TESTIMONY COULD SHED SUBSTANTIAL LIGHT AS TO COSBI'S POSSIBILITIES IN THE CREDIT MARKETS. HOWEVER, WE HAVE PREVIOUSLY INDICATED OUR CONCERN THAT COSBI'S UNDERLYING PORTFOLIO OF SMALL VENTURE FINANCINGS WOULD OBVIOUSLY BE LESS SECURE AND DIVERSE THAN, FOR EXAMPLE, FNMA'S RESIDENTIAL MORTGAGE PORTFOLIO, A SIGNIFICANT AMOUNT OF WHICH IS FEDERALLY INSURED. THUS, THE POSSIBILITY THAT COSBI MIGHT HAVE TO CALL UPON TREASURY'S CONTINGENT LENDING AUTHORITY IS MUCH GREATER. FOR THIS REASON, THIS BILL SHOULD MAKE CLEAR THAT SUCH AUTHORITY WOULD ONLY BE AVAILABLE TO PROTECT COSBI'S CREDITORS, AND NOT TO PROVIDE ADDITIONAL FUNDS TO SBIC'S OR TO SUBSIDIZE THEIR BORROWING COSTS. SUCH STIPULATIONS WOULD NOT ONLY BE

PRUDENT ON THE PART OF THE GOVERNMENT BUT WOULD ALSO SEEM TO BETTER SERVE COSBI'S ABILITY TO OBTAIN FUNDS BY VIRTUE OF INVESTOR RELIANCE ON ITS GOVERNMENT AGENCY STATUS.

LONG TERM CONTROL OF COSBI WILL BE ENTIRELY IN THE HANDS OF SBICS AND MESBICS AS THE BILL GIVES THEM EXCLUSIVE RIGHT TO PURCHASE ITS VOTING COMMON STOCK. A BOARD OF DIRECTORS DOMINATED BY SBIC AND MESBIC PERSONNEL WOULD PRESUMABLY OVERSEE POLICY AND ADMINISTRATION, WITH DAY-TO-DAY OPERATING AUTHORITY AND RESPONSIBILITY RESIDING IN A PAID STAFF SERVING AT THE PLEASURE OF THAT BOARD. THIS COMMITTEE CERTAINLY MAY WISH TO CONSIDER INCREASING THE PROPORTION OF PRESIDENTIALLY-APPOINTED BOARD MEMBERS, AT LEAST WHILE THE GOVERNMENT'S FINANCIAL RISK IS DISPROPORTIONATE TO THE PRIVATE SECTOR'S, AND REQUIRE THAT THEY BE "OUTSIDE" DIRECTORS WITHOUT TIES TO THE SBIC INDUSTRY.

HOWEVER, WITH RESPECT TO YOUR CONCERN OVER ADEQUATE SAFEGUARDS OF THE PUBLIC INTEREST AND THE CONTINUING GOVERNMENT EXPOSURE ON THE SBA-GUARANTEED DEBENTURES AND THE TREASURY CREDIT LINE, THE MOST PRACTICAL SAFEGUARDS WOULD BE FINANCIAL CAVEATS UPON COSBI. ENFORCEMENT OF THESE SAFEGUARDS AND OTHER PUBLIC INTEREST NEEDS WOULD BEST BE ACHIEVED BY PROVIDING SBA ADEQUATE AUTHORITY UNDER THIS BILL TO AUDIT, INVESTIGATE AND SEEK ADMINISTRATIVE, CIVIL AND CRIMINAL REMEDIES AS MAY BE WARRANTED WITH RESPECT TO COSBI OR ANY SBIC OR MESBIC.

IN ADDITION TO ASSURING THAT COSBI MIGHT BORROW FROM THE TREASURY FOR CREDITOR PROTECTION PURPOSES ONLY, FOUR OTHER PROVISIONS SHOULD BE INCORPORATED INTO S. 2647. FIRST, NEW LANGUAGE SHOULD BE ADDED TO MAKE SBIC OBLIGATIONS HELD OR GUARANTEED BY THE GOVERNMENT SENIOR TO ANY SBIC BORROWINGS FROM OR OBLIGATIONS GUARANTEED BY COSBI. ALSO, BECAUSE COSBI'S MANAGEMENT OF THE SBIC INDUSTRY WILL AFFECT SBA'S GUARANTEED CREDITOR POSITION, IT SHOULD BE AT RISK ON THE DEBENTURES IT PURCHASES THAT CARRY SBA'S GUARANTEE. ACCORDINGLY, THIS BILL SHOULD REQUIRE THAT COSBI ESTABLISH A FUNDED LOSS RESERVE TO REIMBURSE THE GOVERNMENT FOR ITS AGGREGATED LOSS. IN CONNECTION WITH THAT LOSS RESERVE PROVISION, COSBI SHOULD BE PROHIBITED FROM MAKING ANY DISTRIBUTIONS, PAYING DIVIDENDS ON ITS VOTING COMMON STOCK, OR REPURCHASING ANY OF ITS VOTING COMMON STOCK UNTIL IT HAS MET ITS OBLIGATIONS, IF ANY, UNDER THAT PROVISION.

LAST, COSBI SHOULD BE REQUIRED TO PROMPTLY FURNISH TO SBA COPIES OF ALL ANNUAL AUDITS OR OTHER REPORTS FILED WITH IT BY SBICS WHICH HAVE OUTSTANDING SECURITIES HELD OR GUARANTEED BY SBA. THESE FIVE PROVISIONS, IF INCORPORATED IN S. 2647, WOULD PROVIDE A BETTER INCENTIVE FOR CAREFUL MANAGEMENT OF COSBI DURING THE PERIOD THAT THE GOVERNMENT REMAINED AT RISK.

I AM AWARE OF AND IN AGREEMENT WITH THE VIEWS OF SBA'S INSPECTOR GENERAL ON THIS PROPOSED LEGISLATION AS SET FORTH IN HER LETTER TO YOU OF JULY 28, 1986. I AM THEREFORE LIMITING MY REMARKS IN THE EXPECTATION THAT INSPECTOR GENERAL MARY WIESEMAN WILL ADVISE YOU IN SOME DETAIL CONCERNING AUDIT, INVESTIGATION, AND CRIMINAL ENFORCEMENT CONSIDERATIONS, PARTICULARLY AS THEY MAY RELATE TO THE PUBLIC POLICY PURPOSES OF COSBI.

YOUR COMMENT IN THE CONGRESSIONAL RECORD THAT STATES:

> "... DESPITE OUR HOPES AND EXPECTATIONS THAT COSBI WILL PROVE A FINANCIAL SUCCESS, THERE IS ALWAYS THE RISK THAT THINGS WON'T GO AS ANTICIPATED. IN THAT EVENT, WE WANT TO BE SURE TO ESTABLISH THE PROPER SAFEGUARDS TO PROTECT THE PUBLIC INTEREST IN THE CONTEXT OF ASSURING THAT THE PURPOSES OF THE SMALL BUSINESS INVESTMENT ACT ARE BEING FULFILLED."

IS VERY WELL TAKEN AND WE BELIEVE THAT IF THE AFOREMENTIONED RECOMMENDATIONS AND THOSE OF THE INSPECTOR GENERAL ARE INCORPORATED IN THIS BILL, THE ADEQUACY OF SUCH SAFEGUARDS WOULD BE SIGNIFICANTLY IMPROVED. THIS SHOULD NOT, HOWEVER, BE CONSIDERED AS THIS ADMINISTRATION'S ENDORSEMENT OF ANY BILL INCLUDING SUCH RECOMMENDATIONS. FEW IF ANY OF THESE SAFEGUARDS WOULD BE NECESSARY IF THE BILL'S PROVISIONS WOULD CANCEL SBA'S

GUARANTEE ON THE SBIC DEBENTURES THAT WOULD BE SOLD TO COSBI AND IF THERE WAS NO BACK UP CREDIT LINE FROM THE U.S. TREASURY.

IN SUMMARY, IT IS OUR OPINION THAT S. 2647 DOES NOT PRIVATIZE THE SBIC PROGRAM IN A FINANCIAL SENSE AND THAT, AS PROPOSED, THE BILL WOULD CREATE A SUBSTANTIAL IMBALANCE BETWEEN THE FEDERAL GOVERNMENT'S FINANCIAL RISK AND PUBLIC POLICY PROGRAMMATIC RISK, AND ITS ABILITY TO OVERSEE AND MANAGE THAT RISK IN A PRUDENT MANNER IN THE PUBLIC INTEREST. THEREFORE, WE CANNOT SUPPORT IT IN ITS PRESENT FORM.

MR. CHAIRMAN, THIS LEGISLATION IS ALSO IN CONFLICT WITH THIS ADMINISTRATION'S EFFORTS TO PRIVATIZE THE EXISTING GOVERNMENT SPONSORED ENTERPRISES (GSEs) AFTER WHICH COSBI IS APPARENTLY PATTERNED. THESE GSEs, INCLUDING "FANNIE MAE", "GINNIE MAE" AND "SALLIE MAE", AS THEY ARE KNOWN, ENJOY SPECIAL ADVANTAGES OVER FULLY PRIVATE BORROWERS IN THE CREDIT MARKETS. THEIR FEDERAL TIES, WHICH INCLUDE STANDBY BORROWING AUTHORITY FROM THE TREASURY, FOR SOME EXEMPTION FROM SECURITIES REGULATION, AND TREATMENT OF THEIR SECURITIES IN THE SAME MANNER AS TREASURY INSTRUMENTS, ENABLE THEM TO BORROW AT LOWER INTEREST RATES THAN THEY WOULD OTHERWISE EXPERIENCE. THE LOWER BORROWING COSTS CONSTITUTE IMPLICIT SUBSIDIES TO SPECIAL CATEGORIES OF BORROWERS, IN THIS CASE SOME 500 SBIC'S AND MESBIC'S.

YOU, MR. CHAIRMAN, AND THE OTHER PAST AND PRESENT MEMBERS OF THIS COMMITTEE, HAVE BEEN DILIGENT IN YOUR REGULATORY, FINANCIAL, AND PUBLIC POLICY OVERSIGHT OF THE SBIC PROGRAM. AT THE SAME TIME, YOU HAVE BEEN SENSITIVE TO THE DELICATE BALANCE THAT MUST BE MAINTAINED IN THIS PROGRAM BETWEEN REGULATION AND OVERSIGHT, AND PRIVATE SECTOR FREEDOM OF ACTION IN PURSUIT OF FINANCIAL GAIN. YOUR SUPPORT HAS ENABLED US TO PRESERVE THAT DELICATE BALANCE AND TOGETHER WE MUST CONTINUE TO ENSURE THAT BALANCE EVEN IN THIS PRIVATIZATION EFFORT.

THANK YOU FOR GIVING US THIS OPPORTUNITY TO TESTIFY AND WE STAND READY TO ANSWER ANY QUESTIONS YOU MAY HAVE.

The CHAIRMAN. Thank you, Mr. Turnbull.

Why don't we go to the Inspector General first, and then have questions.

Ms. Wieseman.

STATEMENT OF MARY F. WIESEMAN, INSPECTOR GENERAL, SMALL BUSINESS ADMINISTRATION

Ms. WIESEMAN. Thank you, Mr. Chairman. It is a pleasure to be here this morning to participate in these hearings.

I am here as the Inspector General of the Small Business Administration, presenting the views of the Office of Inspector General. I am not here representing the Administration in connection with these comments.

This legislation would fundamentally change the operation of the SBIC Program from how it has functioned over the past 28 years. While the Office of Inspector General of the Small Business Administration believes that the concept of privatizing the SBIC Program has merit, we have several distinct concerns with S. 2647.

We are concerned that the role proposed for the Federal Government and the SBA in regulating COSBI will not be adequate. Our concerns relate primarily to the audit and investigative provisions of the bill in sections 358 and 360, as well as the related issue of the elimination of SBA's regulatory oversight authority.

Section 357(e) of the bill provides that 30 days after COSBI informs SBA that the permanent board of directors for COSBI has been duly constituted, and that COSBI is ready to do business, certain provisions of the Small Business Investment Act will no longer be applicable for those SBIC's that are qualified to conduct business with COSBI under the act.

The provisions which will be extinguished include the penal provisions incorporated from the Small Business Act through section 308 of the Small Business Investment Act and section 310 of the Small Business Investment Act, which contains the audit and investigative authorities for SBA.

In place of those audit and investigative authorities, the bill would contain what we consider to be a fragmented and unclearly defined regulatory framework. I will treat the audit issues first. The bill has several relevant sections.

Section 358(i) provides that each SBIC will be subject to an annual audit and will make reports to COSBI at the times and in such format which COSBI prescribes. It appears that these SBIC audits would be financial audits, although the scope of the audit is not defined.

Section 310 of the Small Business Investment Act now requires that the SBIC's be examined annually by SBA. SBA's examinations are compliance audits and measure the SBIC's adherence to SBA's rules and regulations as well as their financial condition. Therefore, COSBI's requirement for audits of SBIC's is quite different and much narrower than the current audit requirements.

Section 360(a) of the bill will authorize SBA to review COSBI's activities, including its agreements and rules and regulations, to ensure that the public purposes of the act are carried out. It is not clear what such a review will involve, except that the bill specifically excludes any review of COSBI's personnel, salary, and other usual corporate matters.

Section 360(b) of the bill will authorize SBA to examine COSBI's books and records. It will also require COSBI to make such reports as SBA deems desirable.

Section 360(c) will require COSBI to have annual financial audits, which will be conducted by independent certified public accountants. The annual audit report will be provided to the Secretary of the Treasury, who will make a report on the annual COSBI audits to the President and the Congress.

Copies of that report will also be given to SBA and to COSBI. COSBI would be subject to audit by the General Accounting Office [GAO], for as long as it holds SBIC securities guaranteed by the SBA.

Finally, COSBI would be required to submit its own report on its activities after each fiscal year to the President, the Congress, and the SBA.

What this bill does not provide for is general regulatory authority in SBA to regulate this new entity. Nor does it provide for any audit access to the small business investment companies by SBA.

We believe, based on the experience of the Office of Inspector General in conducting annual audits of the small business investment companies for the past 19 years, that independent oversight of the industry is necessary to assure that it operates as Congress intended.

We question whether the fragmented oversight framework established by this bill, which mixes Government and industry, will sufficiently assure that the public purposes of COSBI are as well served as the private business purposes.

We believe that S. 2647 should be revised to provide additional oversight authority. We suggest that SBA and this office be provided with the authority to: Exercise general regulatory authority; obtain certified copies of all audit reports on COSBI and the SBIC's, and have access to workpapers supporting all such audits by Government or non-Government auditors; and audit books and records of COSBI, participating SBIC's, and small business concerns financed by the SBIC's.

In making these recommendations we have had the benefit of a General Accounting Office report on the Federal National Mortgage Association. The report is entitled "Federal National Mortgage Association in a Changing Environment." I would like to submit a summary of the GAO report with my statement for the record.[1]

The **Chairman**. It will be included in the record.

Ms. **Wieseman**. Thank you.

FNMA structure closely resembles the proposed COSBI structure. So that the experience with oversight of FNMA, which has operated in its current status since 1968, is particularly instructive, we believe, in attempting to devise a regulatory framework for COSBI.

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[1] GAO's report entitled "Federal National Mortgage Association in a Changing Environment," GAO/RCED-85-102, April 15, 1985, available through the U.S. General Accounting Office Document Handling and Information Services Facilities, P.O. Box 6015, Gaithersburg, MD 20877, (202) 275-6241.

GAO concluded that FNMA's activities should be continually and periodically evaluated and audited. Specifically, GAO recommended that Congress establish by legislation a permanent oversight function within the Department of Housing and Urban Development, or name another Federal regulatory entity that will monitor FNMA activities, evaluate how well it performs its public policy obligation, and periodically report to the Congress in these matters.

It is significant to note that GAO found weaknesses in the oversight of FNMA, even though the statute provides more comprehensive Federal oversight than is provided for COSBI. For example, by statute, HUD has general regulatory authority over FNMA operations. Under the COSBI bill, SBA will not have regulatory oversight authority, but only review authority over COSBI.

HUD has the authority to examine and audit the books and records of FNMA. Under the COSBI bill, SBA will have the authority to examine the corporation's books and records.

The COSBI legislation proposes to begin a new type of privatized SBIC Program, with most, if not all, of the Government ties and privileges characteristic of FNMA. However, the legislation provides significantly less general regulatory and audit power over the principal components of the COSBI Program by SBA, the Government agency most experienced in overseeing SBIC Program operations.

The GAO's analysis of the issues relating to Federal oversight and regulation of FNMA suggests to us that at least for so long as COSBI's ties to the Government are maintained, that is, while SBA has any contingent liability and exposure from the continuation of its guarantees on debentures sold to COSBI, the backstop of Treasury borrowing is available, with the attendant public expectation that the Government is committed to assuring the success of the enterprise and COSBI borrowings can be made at comparable rates to those applicable to Federal agencies. SBA should have more general regulatory and audit authority than is currently provided in the bill.

We are not saying that the SBA's regulations need be as comprehensive as they are now, or that SBA should continue to conduct annual audits of SBIC's. However, SBA should have the ability to exercise regulatory and audit authorities, as necessary, to assure that the public purposes of the legislation are being fulfilled, that risks incurred by the corporation as a consequence of its own actions or outside factors do not unreasonably cause the Government to have unwarranted financial exposure, and that Congress is provided with sufficient information to fulfill its oversight responsibilities.

For these reasons, we believe—and I reiterate—that if the COSBI proposal becomes law, it should provide that SBA have general regulatory authority; all audit reports on COSBI and the SBIC be provided to SBA, and allow SBA access to work papers supporting all such audits by Government or non-Government auditors; and that SBA have the authority to audit books and records of COSBI, participating SBIC's, and small business concerns financed by the SBIC's.

With regard to the investigatory authority under the act, I have in my statement a summary of the investigatory results that our office has had over the last number of years.

There is one change I would like to make in my prepared statement.

Since January 1, 1976, we have initiated a total of 125 cases involving small business investment companies and minority enterprise small business investment companies.

Of that number, it should be 60, or 48 percent, were referred to U.S. attorneys for prosecution.

Of the cases referred, 19 cases, or 15.2 percent, resulted in indictments. Eighteen of those nineteen cases resulted in convictions. The other indictment is pending.

In addition to criminal prosecutions, we have had 45 cases, or 36 percent, where the agency has taken significant action on the licensee; that is, where the SBIC's license was either revoked or surrendered, an application for a license or for funding was refused, or the SBIC was placed in liquidation as a result of our investigations.

We currently have 18 cases under active investigation. We also have four cases where the U.S. attorney's office decision on whether to accept or decline prosecution is pending.

Most of our SBIC investigations are initiated as a result of referral by the audit division of the office, based on the facts developed during the annual examination. We also receive referrals from the investment division, and occasionally from this committee.

Under COSBI, our concern with the investigative implications of the bill begin with section 358(j) of the bill, taken together with 357(e). Section 358(j) states in pertinent part:

> In appropriate cases, the corporation is authorized, in its discretion, to refer violations of the provisions of this section to the SBA for investigation or to refer such violations to the United States Attorney in the jurisdiction in which such violations may have occurred or in which the small business investment company, or its officers or directors, are located.

If this provision is intended to prescribe any kind of reporting and referral responsibility, a provision as qualified and tentative as this one would be unlikely to operate effectively.

Moreover, this section, by its terms, applies only to reporting violations by SBIC's, and then only violations under this section of the bill.

Even if the language were to be broadened to require a report of violations under the act, it would not add anything significant, because section 357(e) of the bill would extinguish both the criminal and civil enforcement provisions of the Small Business and the Small Business Investment Acts, once the COSBI notified SBA that it was ready to begin operations.

Thus, we see no basis for referring any matter under this provision to the U.S. attorney, since it does not appear the U.S. attorney would have authority to act on such referral.

We believe that the reporting and referral provision of section 358(j) should, at a minimum, be broadened to authorize COSBI to report and refer violations of law by SBIC's or other parties, such as the small business concerns, to the SBA or to the cognizant U.S. attorney.

Also, if COSBI makes a referral to a U.S. attorney, COSBI should be required to promptly send a copy of the referral to the SBA inspector general. This additional step would help prevent any fragmenting of reports of wrongdoing and would enable us to obtain the information to report on any significant abuses to Congress in our semiannual reports.

Another potential problem with the proposed legislation is that it is unclear whether the Office of Inspector General would have the authority to conduct any investigation of a violation by an SBIC under either the Small Business Investment Act or the Inspector General Act.

Authority to investigate violations of law and regulations by SBIC's under the Small Business Investment Act would be eliminated by section 357(e) of the bill. Authority to investigate violations of law by SBIC's under the Inspector General Act, particularly in the absence of general regulatory authority by SBA, might be lacking if SBIC violations were not deemed to be matters, "relating to programs or operations of the agency" within the meaning of section 4(a)(1) of the Inspector General Act.

Another problem with the bill is that when section 308 of the Small Business Investment Act is extinguished, it will eliminate the applicability of the criminal false statement provision at section 16 of the Small Business Act, which is made applicable to the SBIC program through section 308 of the Small Business Investment Act.

We strongly urge the retention of the criminal offense found at 15 U.S.C. section 645(a).

We also note that if COSBI is created, appropriate modifications of provisions of title 18, which are currently applicable to SBIC's, should also be considered.

Specifically, 18 U.S.C. section 1006 proscribes false statements by anyone connected with certain designated entities, including SBIC's, to those entities or to any Government agency, with intent to defraud or deceive those entities or agencies.

We recommend an amendment to 1006 to include COSBI with the other named or described entities.

Similarly, 18 U.S.C. section 1014 prohibits false statements or overvaluations of land, property or securities for the purpose of influencing the actions of a number of named or described Federal banks, corporations or licensees, including SBIC's.

We recommend that this section be amended to include COSBI among the entities to be protected from such false statements and overvaluations.

In closing, I hope that these comments on the regulatory and investigative oversight issues raised by the COSBI proposal are of assistance to the Committee on Small Business, and I appreciate the committee's giving me an opportunity to present these views.

[The prepared statement of Ms. Wieseman follows:]

SBA
U.S. Small Business Administration
Washington, DC 20416

STATEMENT OF
MARY F. WIESEMAN
INSPECTOR GENERAL
SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

AUGUST 7, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

IT IS A PLEASURE TO BE HERE THIS MORNING TO PARTICPATE IN YOUR HEARINGS ON S. 2647, A BILL TO CREATE A PRIVATELY-OWNED, FEDERALLY CHARTERED CORPORATION FOR SMALL BUSINESS INVESTMENT, COSBI. MY COMMENTS WILL ADDRESS REGULATORY AUDIT AND INVESTIGATIVE OVERSIGHT ISSUES.

S. 2647 WOULD AMEND THE SMALL BUSINESS INVESTMENT ACT AND WOULD TRANSFER FUNCTIONS PERFORMED BY AND SECURITIES OWNED OR GUARANTEED BY THE SMALL BUSINESS ADMINISTRATION (SBA) TO A FEDERALLY-CHARTERED PRIVATE CORPORATION TO BE KNOWN AS THE CORPORATION FOR SMALL BUSINESS INVESTMENT OR COSBI. COSBI WOULD SERVE AS A SECONDARY MARKET AND WAREHOUSING FACILITY FOR LOANS AND INVESTMENTS IN SMALL BUSINESS INVESTMENT COMPANIES (SBICs).

THIS LEGISLATION WOULD FUNDAMENTALLY CHANGE THE OPERATION OF THE SBIC PROGRAM FROM HOW IT HAS FUNCTIONED OVER THE PAST 28 YEARS. WHILE THIS OFFICE BELIEVES THAT THE CONCEPT OF "PRIVATIZING" THE SBIC PROGRAM MERITS CONSIDERATION, WE HAVE SEVERAL DISTINCT CONCERNS WITH S. 2647.

WE ARE CONCERNED THAT THE ROLE PROPOSED FOR THE FEDERAL GOVERNMENT AND THE SBA IN REGULATING COSBI WILL NOT BE ADEQUATE. OUR CONCERNS RELATE PRIMARILY TO THE AUDIT AND INVESTIGATION PROVISIONS OF THE BILL IN SECTIONS 358 AND 360, AS WELL AS THE RELATED ISSUE OF THE ELIMINATION OF SBA'S REGULATORY OVERSIGHT AUTHORITY.

SECTION 357(E) OF THE BILL PROVIDES THAT, 30 DAYS AFTER COSBI INFORMS SBA THAT THE PERMANENT BOARD OF DIRECTORS FOR COSBI HAS BEEN DULY CONSTITUTED AND THAT COSBI IS READY TO DO BUSINESS, CERTAIN PROVISIONS OF THE SMALL BUSINESS INVESTMENT ACT WILL NO LONGER BE APPLICABLE TO THOSE SBICs THAT ARE QUALIFIED TO CONDUCT BUSINESS WITH COSBI UNDER THE ACT. THE PROVISIONS WHICH WILL BE EXTINGUISHED INCLUDE THE PENAL PROVISIONS INCORPORATED FROM THE SMALL BUSINESS ACT THROUGH SECTION 308 OF THE SMALL BUSINESS INVESTMENT ACT AND SECTION 310 WHICH CONTAINS THE AUDIT AND INVESTIGATION AUTHORITIES FOR THE SBA.

IN PLACE OF THESE AUDIT AND INVESTIGATIVE AUTHORITIES. THE BILL WOULD CONTAIN WHAT WE CONSIDER TO BE A FRAGMENTED AND UNCLEARLY DEFINED REGULATORY FRAMEWORK. I WILL TREAT THE AUDIT ISSUES FIRST. THE BILL HAS SEVERAL RELEVANT SECTIONS.

SECTION 358(I) PROVIDES THAT EACH SBIC WILL BE "SUBJECT TO" AN ANNUAL AUDIT, AND WILL MAKE REPORTS TO COSBI AT THE TIMES AND IN SUCH FORMAT WHICH COSBI PRESCRIBES. IT APPEARS THAT THESE SBIC AUDITS WOULD BE FINANCIAL AUDITS ALTHOUGH THE SCOPE OF THE AUDIT IS NOT DEFINED. SECTION 310 OF THE SMALL BUSINESS INVESTMENT ACT NOW REQUIRES THAT THE SBICs BE EXAMINED ANNUALLY BY SBA. SBA'S EXAMINATIONS ARE COMPLIANCE AUDITS AND MEASURE THE SBICs ADHERENCE TO SBA'S RULES AND REGULATIONS AS WELL AS THEIR FINANCIAL CONDITION. THEREFORE, COSBI'S REQUIREMENT FOR AUDITS OF SBICs IS QUITE DIFFERENT AND MUCH NARROWER THAN THE CURRENT AUDIT REQUIREMENTS.

SECTION 360(A) OF THE BILL WILL AUTHORIZE SBA TO "REVIEW" COSBI'S ACTIVITIES, INCLUDING ITS AGREEMENTS AND RULES AND REGULATIONS TO ENSURE THAT THE PUBLIC PURPOSES OF THE ACT ARE CARRIED OUT. IT IS NOT CLEAR WHAT SUCH A "REVIEW" WILL INVOLVE EXCEPT THAT THE BILL SPECIFICALLY EXCLUDES ANY REVIEW OF COSBI'S INTERNAL PERSONNEL, SALARY AND OTHER USUAL CORPORATE MATTERS.

SECTION 360(B) OF THE BILL WILL AUTHORIZE SBA TO "EXAMINE" COSBI'S BOOKS AND RECORDS. IT WILL ALSO REQUIRE COSBI TO MAKE SUCH REPORTS AS SBA DEEMS DESIRABLE.

SECTION 360(c) WILL REQUIRE COSBI TO HAVE ANNUAL FINANCIAL AUDITS WHICH WILL BE CONDUCTED BY INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS. THE ANNUAL AUDIT REPORT WILL BE PROVIDED TO THE SECRETARY OF THE TREASURY, WHO WILL MAKE A REPORT ON THE ANNUAL COSBI AUDITS TO THE PRESIDENT AND THE CONGRESS. COPIES OF THAT REPORT WILL ALSO BE GIVEN TO SBA AND TO COSBI. COSBI WOULD BE SUBJECT TO AUDIT BY THE GENERAL ACCOUNTING OFFICE (GAO) FOR AS LONG AS IT HOLDS SBIC SECURITIES GUARANTEED BY THE SBA. FINALLY, COSBI WOULD BE REQUIRED TO SUBMIT ITS OWN REPORT ON ITS ACTIVITIES AFTER EACH FISCAL YEAR TO THE PRESIDENT, THE CONGRESS AND THE SBA.

WHAT THIS BILL DOES NOT PROVIDE FOR IS GENERAL AUTHORITY IN SBA TO REGULATE THIS NEW ENTITY. NOR DOES IT PROVIDE FOR ANY AUDIT ACCESS TO THE SMALL BUSINESS INVESTMENT COMPANIES. WE BELIEVE, BASED ON THE EXPERIENCE OF THE OFFICE OF INSPECTOR GENERAL IN CONDUCTING ANNUAL AUDITS OF THE SMALL BUSINESS INVESTMENT COMPANIES FOR THE PAST 19 YEARS, THAT INDEPENDENT OVERSIGHT OF THE INDUSTRY IS NECESSARY TO ASSURE THAT IT OPERATES AS CONGRESS INTENDED.

WE QUESTION WHETHER THE FRAGMENTED OVERSIGHT FRAMEWORK ESTABLISHED BY THIS BILL, WHICH MIXES GOVERNMENT AND INDUSTRY, WILL SUFFICIENTLY ASSURE THAT THE PUBLIC PURPOSES OF COSBI ARE AS WELL SERVED AS THE PRIVATE BUSINESS PURPOSES. WE BELIEVE THAT S. 2647 SHOULD BE REVISED TO PROVIDE ADDITIONAL OVERSIGHT AUTHORITY. WE SUGGEST THAT SBA AND THIS OFFICE BE PROVIDED WITH THE AUTHORITY TO:

1. EXERCISE GENERAL REGULATORY AUTHORITY;
2. OBTAIN CERTIFIED COPIES OF ALL AUDIT REPORTS ON COSBI AND THE SBICS, AND HAVE ACCESS TO WORKPAPERS SUPPORTING ALL SUCH AUDITS BY GOVERNMENT OR NON-GOVERNMENT AUDITORS; AND
3. AUDIT BOOKS AND RECORDS OF COSBI, PARTICIPATING SBICS AND SMALL BUSINESS CONCERNS FINANCED BY THE SBICS.

IN MAKING THESE RECOMMENDATIONS, WE HAVE HAD THE BENEFIT OF A GENERAL ACCOUNTING OFFICE REPORT ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA). THE REPORT IS ENTITLED "THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN A CHANGING ENVIRONMENT." GAO/RCED-85-102, APRIL 15, 1985. I WOULD LIKE TO SUBMIT A COPY OF THIS GAO REPORT WITH MY STATEMENT FOR THE RECORD.

FNMA STRUCTURE CLOSELY RESEMBLES THE PROPOSED COSBI STRUCTURE, SO THAT THE EXPERIENCE WITH OVERSIGHT OF FNMA, WHICH HAS OPERATED IN ITS CURRENT STATUS SINCE 1968, IS PARTICULARLY INSTRUCTIVE IN ATTEMPTING TO DEVISE A REGULATORY FRAMEWORK FOR COSBI.

GAO CONCLUDED THAT FNMA'S ACTIVITIES SHOULD BE CONTINUALLY MONITORED AND PERIODICALLY EVALUATED AND AUDITED. SPECIFICALLY, GAO RECOMMENDED THAT CONGRESS "ESTABLISH BY LEGISLATION A PERMANENT OVERSIGHT FUNCTION WITHIN THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT OR NAME ANOTHER FEDERAL REGULATORY ENTITY THAT WILL MONITOR FNMA ACTIVITIES, EVALUATE HOW WELL IT PERFORMS ITS PUBLIC POLICY OBLIGATION, AND PERIODICALLY REPORT TO CONGRESS ON THESE MATTERS."

IT IS SIGNIFICANT TO NOTE THAT GAO FOUND WEAKNESSES IN THE OVERSIGHT OF FNMA EVEN THOUGH THE STATUTE PROVIDES MORE COMPREHENSIVE FEDERAL OVERSIGHT THAN IS PROVIDED FOR COSBI. FOR EXAMPLE, BY STATUTE, HUD HAS GENERAL REGULATORY AUTHORITY OVER FNMA OPERATIONS; UNDER THE COSBI BILL, SBA WILL NOT HAVE REGULATORY OVERSIGHT, BUT ONLY "REVIEW" AUTHORITY OVER COSBI. HUD HAS THE AUTHORITY TO EXAMINE AND AUDIT THE BOOKS AND RECORDS OF FNMA; UNDER THE COSBI BILL, SBA WILL HAVE THE AUTHORITY ONLY TO "EXAMINE" THE CORPORATION'S BOOKS AND RECORDS.

THE COSBI LEGISLATION PROPOSES TO BEGIN A NEW TYPE OF PRIVATIZED SBIC PROGRAM, WITH MOST, IF NOT ALL, OF THE GOVERNMENT TIES AND PRIVILEGES CHARACTERISTIC OF FNMA. HOWEVER, THE LEGISLATION PROVIDES SIGNIFICANTLY LESS GENERAL REGULATORY AND AUDIT POWER OVER THE PRINCIPAL COMPONENTS OF THE COSBI PROGRAM BY SBA, THE GOVERNMENT AGENCY MOST EXPERIENCED IN OVERSEEING SBIC PROGRAM OPERATIONS.

THE GAO'S ANALYSIS OF THE ISSUES RELATING TO FEDERAL OVERSIGHT AND REGULATION OF FNMA SUGGESTS TO US THAT AT LEAST FOR SO LONG AS COSBI'S TIES TO THE GOVERNMENT ARE MAINTAINED, THAT IS, WHILE SBA HAS ANY CONTINGENT LIABILITY AND EXPOSURE FROM THE CONTINUATION OF ITS GUARANTEES ON DEBENTURES SOLD TO COSBI, THE "BACKSTOP" OF TREASURY BORROWING IS AVAILABLE WITH THE ATTENDANT PUBLIC EXPECTATION THAT THE GOVERNMENT IS COMMITTED TO ASSURING THE SUCCESS OF THE ENTERPRISE, AND COSBI BORROWINGS CAN BE MADE AT COMPARABLE RATES TO THOSE APPLICABLE TO FEDERAL AGENCIES, SBA SHOULD HAVE MORE GENERAL REGULATORY AND AUDIT AUTHORITY THAN IS CURRENTLY PROVIDED IN THE BILL.

WE ARE NOT SAYING THAT SBA REGULATIONS NEED BE AS COMPREHENSIVE AS THEY ARE NOW, OR THAT SBA SHOULD CONTINUE TO CONDUCT ANNUAL AUDITS OF SBICs. HOWEVER, SBA SHOULD HAVE THE ABILITY TO EXERCISE REGULATORY AND AUDIT AUTHORITIES AS NECESSARY TO ASSURE THAT THE PUBLIC PURPOSES OF THE LEGISLATION ARE BEING FULFILLED, THAT RISKS INCURRED BY THE

CORPORATION AS A CONSEQUENCE OF ITS OWN ACTIONS OR OUTSIDE FACTORS DO NOT UNREASONABLY CAUSE THE GOVERNMENT TO HAVE UNWARRANTED FINANCIAL EXPOSURE, AND THAT CONGRESS IS PROVIDED WITH SUFFICIENT INFORMATION TO FULFILL ITS OVERSIGHT RESPONSIBILITIES.

FOR THESE REASONS, WE BELIEVE THAT IF THE COSBI PROPOSAL BECOMES LAW, IT SHOULD PROVIDE THAT:

1) SBA HAVE GENERAL REGULATORY AUTHORITY;
2) ALL AUDIT REPORTS ON COSBI AND THE SBICS BE PROVIDED TO SBA, AND ALLOW SBA ACCESS TO WORKPAPERS SUPPORTING ALL SUCH AUDITS BY GOVERNMENT OR NON-GOVERNMENT AUDITORS; AND
3) SBA AUTHORITY HAVE TO AUDIT BOOKS AND RECORDS OF COSBI, PARTICIPATING SBICS AND SMALL BUSINESS CONCERNS FINANCED BY THE SBICS.

INVESTIGATIVE OVERSIGHT

SINCE JANUARY 1, 1976, WE HAVE INITIATED A TOTAL OF 125 CASES INVOLVING SMALL BUSINESS INVESTMENT COMPANIES AND MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES. OF THAT NUMBER, 58, OR 46.4% WERE REFERRED TO UNITED STATES ATTORNEY'S OFFICES FOR PROSECUTION. OF THE CASES REFERRED, 19 CASES, OR 15.2% RESULTED IN INDICTMENTS. 18 OF THOSE 19 CASES RESULTED IN CONVICTIONS. THE OTHER INDICTMENT IS PENDING. IN ADDITION TO CRIMINAL PROSECUTIONS, WE HAVE HAD

45 CASES, OR 36% WHERE THE AGENCY HAS TAKEN SIGNIFICANT ACTION ON THE LICENSEE, THAT IS WHERE THE SBIC's LICENSE WAS EITHER REVOKED OR SURRENDERED, AN APPLICATION FOR A LICENSE OR FOR FUNDING WAS REFUSED, OR THE SBIC WAS PLACED IN LIQUIDATION AS A RESULT OF OUR INVESTIGATION. (THOSE 45 CASES INCLUDE THE 18 WHICH RESULTED IN CRIMINAL CONVICTIONS.)

WE CURRENTLY HAVE 18 CASES UNDER ACTIVE INVESTIGATION. WE ALSO HAVE 4 CASES WHERE THE UNITED STATES ATTORNEY'S OFFICE DECISION ON WHETHER TO ACCEPT OR DECLINE PROSECUTION IS PENDING.

MOST OF OUR SBIC INVESTIGATIONS ARE INITIATED AS A RESULT OF REFERRAL BY THE AUDIT DIVISION OF THE OFFICE BASED ON THE FACTS DEVELOPED DURING THE ANNUAL EXAMINATION. WE ALSO RECEIVE REFERRALS FROM THE INVESTMENT DIVISION, AND OCCASIONALLY FROM THIS COMMITTEE.

UNDER COSBI, OUR CONCERN WITH THE INVESTIGATIVE IMPLICATIONS OF THE BILL BEGIN WITH §358(J) OF THE BILL, TAKEN TOGETHER WITH 357(E). SECTION 358(J) STATES, IN PERTINENT PART:

> "IN APPROPRIATE CASES, THE CORPORATION IS AUTHORIZED, IN ITS DISCRETION, TO REFER VIOLATIONS OF THE PROVISIONS OF THIS SECTION TO THE [SBA] FOR INVESTIGATION OR TO REFER SUCH VIOLATIONS TO THE UNITED STATES ATTORNEY IN THE JURISDICTION IN WHICH SUCH VIOLATIONS MAY HAVE OCCURRED OR IN WHICH THE SMALL BUSINESS INVESTMENT COMPANY, OR ITS OFFICERS OR DIRECTORS, ARE LOCATED."

IF THIS PROVISION IS INTENDED TO PRESCRIBE ANY KIND OF REPORTING AND REFERRAL RESPONSIBILITY, A PROVISION AS QUALIFIED AND TENTATIVE AS THIS ONE WOULD BE UNLIKELY TO OPERATE EFFECTIVELY. MOREOVER, THIS SECTION BY ITS TERMS ONLY APPLIES TO REPORTING VIOLATIONS BY SBICS, AND THEN, ONLY VIOLATIONS UNDER THIS SECTION OF THE BILL. EVEN IF THE LANGUAGE WERE TO BE BROADENED TO REQUIRE A REPORT OF VIOLATIONS UNDER THE ACT, IT WOULD NOT ADD ANYTHING SIGNIFICANT BECAUSE SECTION 357(E) OF THE BILL WOULD EXTINGUISH BOTH THE CRIMINAL AND CIVIL ENFORCEMENT PROVISIONS OF THE SMALL BUSINESS AND SMALL BUSINESS INVESTMENT ACTS ONCE THE COSBI NOTIFIED SBA THAT IT WAS READY TO BEGIN OPERATIONS. THUS, WE SEE NO BASIS FOR REFERRING ANY MATTER UNDER THIS PROVISION TO THE U.S. ATTORNEY SINCE THE U.S. ATTORNEY WOULD HAVE NO AUTHORITY TO ACT ON SUCH REFERRAL.

WE BELIEVE THAT THE REPORTING AND REFERRAL PROVISION OF §358(J) SHOULD AT A MINIMUM BE BROADENED TO AUTHORIZE COSBI TO REPORT AND REFER VIOLATIONS OF LAW BY SBICs OR OTHER PARTIES, SUCH AS THE SMALL BUSINESS CONCERNS, TO THE SBA OR TO THE COGNIZANT U.S. ATTORNEY. ALSO, IF COSBI MAKES A REFERRAL TO A U.S. ATTORNEY, COSBI SHOULD BE REQUIRED TO PROMPTLY SEND A COPY OF THE REFERRAL TO THE SBA INSPECTOR GENERAL. THIS ADDITIONAL STEP WOULD HELP PREVENT ANY FRAGMENTING OF REPORTS OF WRONGDOING AND WOULD ENABLE US TO OBTAIN THE INFORMATION TO REPORT ON ANY SIGNIFICANT ABUSES TO CONGRESS IN OUR SEMI-ANNUAL REPORTS.

ANOTHER POTENTIAL PROBLEM WITH THE PROPOSED LEGISLATION IS THAT IT IS UNCLEAR WHETHER THE OFFICE OF INSPECTOR GENERAL WOULD HAVE THE AUTHORITY TO CONDUCT ANY INVESTIGATION OF A VIOLATION BY AN SBIC UNDER EITHER THE SMALL BUSINESS INVESTMENT ACT OR THE INSPECTOR GENERAL ACT. AUTHORITY TO INVESTIGATE VIOLATIONS OF LAW AND REGULATIONS BY SBICs UNDER THE SMALL BUSINESS INVESTMENT ACT WOULD BE ELIMINATED BY SECTION 357(E) OF THE BILL. AUTHORITY TO INVESTIGATE VIOLATIONS OF LAW BY SBICs UNDER THE INSPECTOR GENERAL ACT, PARTICULARLY IN THE ABSENCE OF GENERAL REGULATORY AUTHORITY BY SBA, MIGHT BE LACKING IF SBIC VIOLATIONS WERE NOT DEEMED TO BE MATTERS "RELATING TO PROGRAM OR OPERATIONS OF THE AGENCY" WITH THE MEANING OF SECTION 4(A)(1) OF THE INSPECTOR GENERAL ACT. 5 U.S.C. APP.

ANOTHER PROBLEM WITH THE BILL IS THAT WHEN SECTION 308 OF THE SMALL BUSINESS INVESTMENT ACT IS EXTINGUISHED, IT WILL ELIMINATE THE APPLICABILITY OF THE CRIMINAL FALSE STATEMENT PROVISION AT §16 OF THE SMALL BUSINESS ACT WHICH IS MADE APPLICABLE TO THE SBIC PROGRAM THROUGH SECTION 308 OF THE SMALL BUSINESS INVESTMENT ACT. WE STRONGLY URGE THE RETENTION OF THIS CRIMINAL OFFENSE FOUND AT 15 U.S.C. SECTION 645(A)

WE ALSO NOTE THAT IF COSBI IS CREATED, APPROPRIATE MODIFICATIONS OF PROVISIONS OF TITLE 18 WHICH ARE CURRENTLY APPLICABLE TO SBICs SHOULD ALSO BE CONSIDERED.

SPECIFICALLY, 18 U.S.C. SECTION 1006 PROSCRIBES FALSE STATEMENTS BY ANYONE CONNECTED WITH CERTAIN DESIGNATED ENTITIES, INCLUDING SBICs, TO THOSE ENTITIES OR TO ANY GOVERNMENT AGENCY, WITH INTENT TO DEFRAUD OR DECEIVE THOSE ENTITIES OR AGENCIES. WE RECOMMEND AN AMENDMENT TO 1006 TO INCLUDE COSBI WITH THE OTHER NAMED OR DESCRIBED ENTITIES.

SIMILARLY, 18 U.S.C. SECTION 1014 PROHIBITS FALSE STATEMENTS OR OVERVALUATIONS OF LAND, PROPERTY OR SECURITIES FOR THE PURPOSE OF INFLUENCING THE ACTIONS OF A NUMBER OF NAMED OR DESCRIBED FEDERAL BANKS, CORPORATIONS OR LICENSEES, INCLUDING SBICS. WE RECOMMEND THAT THIS SECTION BE AMENDED TO INCLUDE COSBI AMONG THE ENTITIES TO BE PROTECTED FROM SUCH FALSE STATEMENTS AND OVERVALUATIONS.

IN CLOSING, I HOPE THAT THESE COMMENTS ON THE REGULATORY AND INVESTIGATIVE OVERSIGHT ISSUES RAISED BY THE COSBI PROPOSAL ARE OF ASSISTANCE TO THE COMMITTEE ON SMALL BUSINESS AND I APPRECIATE THE COMMITTEE'S GIVING ME AN OPPORTUNITY TO PRESENT THESE VIEWS. I UNDERSTAND THAT THE HOUSE SMALL BUSINESS COMMITTEE HAS ALREADY HELD A MARKUP OF THE COMPANION TO S. 2647. I HOPE THAT FUTURE ACTION BY THIS COMMITTEE WILL ADDRESS THE CONCERNS OF MY OFFICE AND INCORPORATE THE SUGGESTIONS OFFERED HERE TODAY.

THANK YOU AGAIN FOR THE OPPORTUNITY TO PRESENT OUR VIEWS IN THIS MATTER. I AM HAPPY TO ANSWER ANY OF YOUR QUESTIONS AT THIS TIME.

REPORT BY THE COMPTROLLER
GENERAL OF THE UNITED STATES

THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN A CHANGING ECONOMIC ENVIRONMENT

DIGEST

The Federal National Mortgage Association (FNMA or "Fannie Mae") is a federally chartered, private, for-profit corporation that was established to provide funds for residential mortgages. It is subject to oversight and regulation by the Department of Housing and Urban Development (HUD), and its borrowing must be approved by the Treasury. FNMA buys mortgages from mortgage bankers, savings and loan associations, and other lenders and acquires funds for its purchases by issuing various forms of debt securities and stock. It also issues and guarantees securities backed directly by mortgages and collects fees for this service.

FNMA owns an $88 billion portfolio of mortgage loans, many of which carry interest rates well below those it is required to pay in order to borrow in today's market. Much of its debt must be refinanced each year (estimated at $31 billion in 1985), while most of the mortgages in its portfolio are longer term and will not pay off for many years. The mismatch between interest rates on its assets and liabilities has resulted in substantial interest losses over the last 5 years. Throughout the 1970's FNMA was a profitable enterprise; but when interest rates increased rapidly to historic highs in the 1980's, the company began sustaining losses in 1981 and 1982. FNMA employed a strategy of buying new mortgages with higher interest rates and generating income from other sources to offset losses on its existing portfolio. This strategy has resulted in its portfolio growing from $57 billion in 1980 to $88 billion at the end of 1984. Although it has taken other steps to reduce both its interest rate risk and the likelihood of a future financial crisis, FNMA's portfolio growth increases the potential losses it would suffer should interest rates increase substantially (as well as profits if they fall).

If FNMA were a strictly private firm with no federal government connections and with a less prominent place in the financial markets, its activities would be of much less public interest. But the corporation was chartered to serve public policy objectives and enjoys significant financial advantages from its government ties, most importantly lower borrowing costs. And there is a widely held perception in the credit markets that the federal government, although not required to do so by law, would step in with whatever aid was needed if FNMA experienced financial problems. The rationale is that the federal government would wish to avoid any negative impact on the housing industry or on the savings and loans, commercial banks, and other institutions that hold FNMA securities.

It is in this context that a variety of questions regarding FNMA and its operations take on public policy significance.

The Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and subsequently Senator Donald W. Riegle, Jr., and Congressmen Henry B. Gonzalez and Stewart McKinney requested that GAO report on

--how the secondary market for residential mortgages is changing and FNMA's role in that market;

--the privileges and constraints that affect FNMA in its public-purpose role and its profitability as a shareholder-owned corporation;

--the interest rate and credit risks that FNMA incurs and its strategies for dealing with these risks;

--the economic and social benefits that result from FNMA activities; and

--how HUD and the Department of the Treasury, as federal regulators, oversee FNMA activities.

GAO does not have a statutory right of access to FNMA records. While FNMA provided much of the information GAO requested, it would not provide certain detailed records, such as the composition of its portfolio or its foreclosed loans, citing possible harm to its competitive position. In such instances, GAO relied on publicly available FNMA data. (See pp. 6-9.)

CHANGES IN THE MORTGAGE LENDING INDUSTRY

High, volatile interest rates in the late 1970's and early 1980's created a financial crisis for the savings and loan (thrift) industry and FNMA. Thrifts' financial positions deteriorated as depositors found better investments elsewhere and withdrew their deposits. As borrowing costs exceeded low-interest portfolio yields and higher yields on new mortgages depressed the value of older portfolio holdings, the industry's net worth plummeted; and a wave of mergers followed. Similarly, FNMA was caught in a position in which its borrowing costs exceeded the yields on mortgages it held in its portfolio.

By 1983, thrifts had acquired legislative and regulatory relief on three fronts. First, deregulation of deposit interest rates provided them access to funds, albeit at higher interest rates. Second, authorization to issue a variety of mortgage instruments (mainly adjustable rate mortgages) and additional non-housing loans provided them with access to assets that would more nearly match deposits with respect to yield and maturity. And finally, through FNMA and the Federal Home Loan Mortgage Corporation, the thrifts exchanged a large volume of low yield, illiquid mortgages for liquid, mortgage-backed securities. Using newly approved transactions known as "swaps" allowed them to avoid reporting accounting losses while enhancing their reserves. As the thrifts added large volumes of adjustable rate mortgages to their portfolios, their earnings became less vulnerable to increases in interest rates.

FNMA's heavy purchases of mortgages in recent years were fueled by considerations much like those of the thrifts; however, FNMA was not granted permission to acquire non-housing related assets. According to FNMA, its purchases are aimed at increasing income and creating a better match, with respect to yield and maturity, between their portfolio assets and their liabilities (debentures and notes). Toward that end, FNMA also began purchasing adjustable rate mortgages, which comprised 37 percent of loan purchases in 1984. The spread between the interest rates on its assets and liabilities has decreased from a negative 1.5 percentage points in 1981 to a negative 0.7 percentage points in 1984. (See pp. 10-19 and 20.)

PROFITABILITY AND INTEREST RATE RISK

After 12 profitable years, FNMA reported overall losses in 1981 and 1982 and again in 1984. The primary determinant of FNMA's profits and losses was its interest margin--the difference between the interest FNMA earns on its mortgages and other assets and the interest FNMA pays on the money it borrows. However, in the 1981-84 period, such factors as fee income, gains on the sale of mortgages, provisions for foreclosure losses, and administrative expenses were also significant determinants of FNMA's total profits or losses.

Two initiatives FNMA undertook in 1981 have been successful in producing earnings to partially offset the negative interest margins experienced in 1981-1984. These were (1) increasing fee income and (2) earning money from the positive interest margin on the large volume of mortgages purchased in 1981 and later years. These measures have also greatly increased the size of its portfolio. (See pp. 20-25.)

On one hand, these steps together with FNMA's efforts to reduce the maturity of its assets and lengthen the maturity of its debt, could be viewed as reducing the likelihood of a situation in which the implicit federal backing of FNMA's debt became an issue. But the sizeable increase in FNMA's portfolio also has increased the magnitude of the financial assistance the financial community expects the federal government would provide FNMA should it encounter serious financial difficulty. Such difficulty would occur if interest rates rise and remain at higher levels for an extended period, causing losses for FNMA because of the increased negative interest margin. Like many thrift institutions, this "interest rate" risk is the most serious problem that FNMA faces in the future.

Because GAO did not have access to the necessary portfolio data, it could not fully evaluate FNMA's risk reduction efforts or determine whether alternative strategies might have resulted in less risk without reducing profitability.

CREDIT RISK HAS PROBABLY INCREASED

In the process of increasing earnings, FNMA may also have increased credit risk. FNMA's foreclosure losses for 1984 were $87.3 million. Total foreclosure volume was actually much greater, but mortgage insurers reimbursed FNMA for nearly $600 million in 1984. These foreclosure losses were up from $38.4 million in 1983 and $1.6 million in 1982.

FNMA probably increased its exposure to foreclosure when it added a large volume of loans to its portfolio in 1981 through 1984. This was due to a combination of factors including:

--changes in FNMA business practices, such as relying on lenders to ensure that loans sold to FNMA met its underwriting standards;

--property value stagnation; and

--writing loans with payments that increase rapidly during the first few years after origination, regardless of the movement in interest rates.

As a result of its losses, FNMA has taken steps to reduce its potential foreclosure losses in the future, such as stressing the need for lenders to conform to underwriting standards, but the success of these moves cannot be predicted. (See pp. 38-49.)

Improved economic conditions and the resumption of modest property appreciation could be expected to moderate FNMA foreclosure losses in the future since it is largely insured against credit risk by private mortgage insurers.

FNMA BENEFITS TO HOUSING AND MORTGAGE FINANCE AND FEDERAL SUPPORTS

Although individuals, investors, and institutions have always purchased mortgages for investment portfolios, the growth of a national secondary mortgage market really began with FNMA's restructuring in 1968. In cooperation with the Federal Housing Administration (FHA) that insured mortgages providing additional security to investors, FNMA developed standard mortgage instruments and practices and helped create a national market in residential loans. To perform this market building role FNMA was provided with a variety of financial supports, but its business was limited to the residential secondary mortgage market exclusively.

Financial advantages

FNMA receives a variety of financial supports including the following: Treasury authority to purchase FNMA securities under terms that Treasury would prescribe should this ever be necessary; exemption from state and local income taxes and Securities and Exchange Commission (SEC) registration fees; and the ability of regulated financial institutions, such as banks and pension funds, to hold FNMA debt in the same way as Treasury debt. In turn, FNMA's secondary market activity is limited to mortgages below limits established by Congress, currently set at $115,300.

These advantages have saved FNMA millions of dollars in fees and taxes; but, more imporantly, they create the impression that FNMA is an agency of the federal government. This perception allows FNMA to receive the highest private quality rating possible for its debt and to borrow at interest rates that are usually close to those of the U.S. Treasury. Without this advantage, FNMA could be expected to pay substantially higher debt costs and according to FNMA would be unable to operate in the secondary market at anything approaching its present level. In 1983, FNMA's most recent profitable year, a one-half percentage point increase in its average borrowing costs would have cost FNMA an additional $157 million, which would have more than offset its profits for that year.

As FNMA's mortgage portfolio has grown, the aggregate value of these financial advantages has increased. Recent changes in the tax treatment of its losses and modest relaxation of HUD regulatory restrictions on its assets (for example, it can now buy second mortgages) have also added to its profit potential. (See pp. 77-88.)

FNMA benefits to society

FNMA's charter defined its role as providing ". . . supplemental assistance to the secondary market to home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." The purpose was to help establish a secondary market for mortgages. This supplementary assistance function has been interpreted by FNMA and others to encompass a variety of activities. Such activities include redistributing credit geographically, tapping non-traditional sources of funds, and providing mortgage funds when other lenders withdraw from the market during credit crunches. The Charter Act and HUD regulations also require that a reasonable portion of FNMA mortgage purchases assist low- and moderate-income households but with reasonable economic return to the corporation.

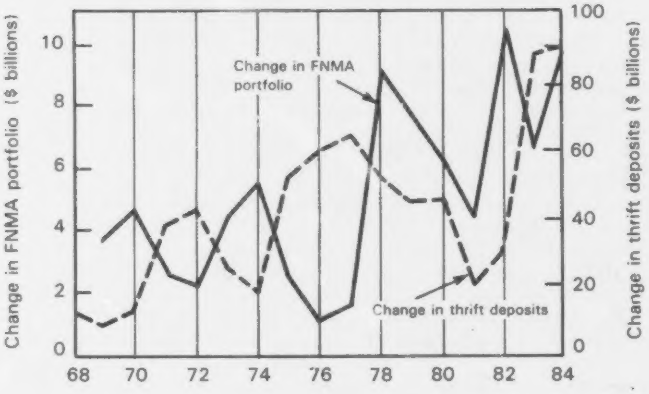
FNMA performed its supplemental assistance and market-building function by serving as a national supplier of mortgage funds, providing an outlet for loans from federal mortgage programs and housing subsidy programs, and increasing its purchases of mortgages during periods of scarce credit. But conditions changed: the primary and secondary mortgage market grew, the thrift industry was deregulated, and other federal credit agencies such as the Government National Mortgage Association (GNMA) became active in the secondary mortgage market. With these changes, certain of the significant benefits that FNMA provided in the 1970's appear to have declined while FNMA has responded to new market demands.

For example, through the mid-1970's FNMA was the principal buyer of FHA/VA single-family and FHA multifamily project loans. A variety of factors have shifted FNMA's new business largely to conventional single-family loans for middle-income households. Government subsidy programs utilizing FHA rental housing loans were phased out, and, until recently, FNMA could not purchase conventional multifamily rental housing mortgages. In addition, GNMA began guaranteeing FHA/VA mortgage-backed securities in 1970, providing a lower-cost source of funds for these loans, while FNMA moved into the conventional mortgage market in 1972. As a result, conventional loans began to dominate FNMA purchases in 1976 and amounted to nearly 99 percent of its purchases in 1983. (See pp. 56-74.)

Furthermore, in earlier credit cycles, increases in interest rates and the resulting decrease in deposits at thrift institutions caused by limits on what they could pay depositors, created a natural countercyclical role for FNMA. It could

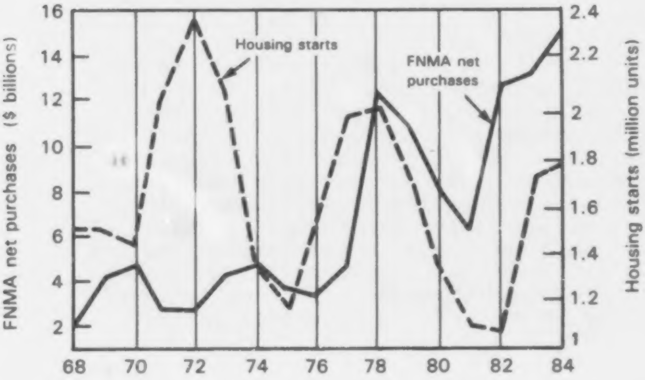
Figure 1
FNMA's Countercyclical Role

FNMA's portfolio activity tended to offset declines in thrift deposits in the early 1970's . . .



. . . but in the 1979-1984 period FNMA and thrift deposits generally moved in the same direction.

FNMA has typically increased its mortgage purchases as housing production falls . . .



. . . but FNMA purchases moved down with housing starts beginning in 1979 and rebounded in the 3rd quarter of 1981 just before starts picked up in the 2nd quarter of 1982.

Source: FNMA and Data Resources, Inc.

still borrow and, therefore, absorb mortgage-lending business lost by savings and loans and other depositories through its purchase of loans from mortgage lenders. Deregulation and the resulting closer integration of housing finance into the credit markets have probably reduced this FNMA role. In the last housing downturn, when thrifts were still limited to some extent by interest rate ceilings, FNMA's activity did not appear to be countercylical. (See figure 1.) Rather, its loan activity seemed to follow the trends in thrift deposits and did not increase as housing starts declined or decrease as mortgage lending in general rebounded. (See pp. 62-63.) FNMA contends that its role has changed from one of improving the supply of credit prior to 1980, to one of decreasing the cost of credit during downturns in housing. Based upon the information provided by FNMA, GAO was unable to verify this contention. FNMA also notes that it taps a broader investor base than other secondary market participants because it can issue short and intermediate term debt that is attractive to investors who would not invest in mortages or mortgage backed securities.

HUD HAS NOT FULLY EXERCISED ITS OVERSIGHT ROLE; TREASURY'S ROLE ROUTINE

In setting up FNMA as a private corporation, Congress recognized that safeguards, in terms of HUD and Treasury oversight, were needed to ensure that FNMA would carry out its public functions and use its borrowing powers in a responsible way. (See pp. 89-103.)

HUD oversight and regulation

Under FNMA's charter, HUD is empowered to issue rules and regulations to ensure that the act's purposes are accomplished, review FNMA's financial operations, and prepare studies on the extent to which FNMA meets the purposes of the act. Certain of these regulatory powers must be exercised consistent with maintaining a reasonable economic return to FNMA and its stockholders. Also, HUD regulation may not extend to "usual" corporate matters, such as setting salaries. For the most part, the act gave HUD considerable discretion in the extent to which it regulates and oversees FNMA. HUD has carried out some of its oversight activities, such as issuing regulations and reviewing FNMA requests to undertake new programs. Within the limits of its review, GAO identified several areas in which HUD's oversight performance has fallen short of what GAO believes Congress envisioned in the charter:

--The Charter Act called for HUD oversight of FNMA operations. While HUD established a FNMA oversight unit within its Office of General Counsel shortly after issuing its 1978 revised regulations, the unit was disbanded in 1981. Presently HUD has no staff dedicated exclusively to FNMA oversight.

--Although HUD has audit authority and access to FNMA records, it has chosen not to utilize its audit authority in favor of FNMA's independent financial auditors. This may be consistent with the private, but not necessarily the public-purpose, side of FNMA's identity. HUD has not directly accessed FNMA's files and records and, therefore, data on certain aspects of FNMA operations, having public policy implications, are not available to the government or the Congress.

--HUD has not analyzed the financial risk to which FNMA exposes the government or evaluated alternative risk management strategies which FNMA might pursue.

--More generally HUD has not undertaken a study of how well FNMA still serves its public purpose role. For example, it has not recently attempted to determine whether a reasonable portion of FNMA's purchases benefit low- and moderate-income households and no longer requires FNMA to submit the information necessary to do so.

--HUD has not submitted a report on FNMA activities required by Congress since 1978. Recent legislation dropped this requirement in favor of an annual report but HUD says it is now preparing the originally required report voluntarily.

HUD officials responsible for oversight and regulation are unsure of the nature of their role. They believe the public-sector regulation of a private-sector corporation as laid out in the charter was inconsistent. HUD officials told GAO they have no clear sense of what regulations are needed to ensure that charter purposes are achieved, the specific FNMA activities HUD should regulate, or whether HUD should or could develop the capability and expertise to be a "watchdog" over FNMA's risk management activities. Finally, HUD officials do not believe the Department presently has the capacity or expertise to perform certain functions which might be expected of a financial institution regulator, such as monitoring FNMA's interest rate risk.

GAO believes that the relationship between FNMA and the government is quite different than that of other regulated industries. FNMA's ties to the government and its implicit "agency status" imply the government's oversight should extend to evaluating the reasonableness of the risk FNMA is taking and the degree to which it is achieving public purposes.

Treasury oversight

Treasury controls FNMA debt through approval of new issuances of FNMA's debt securities. The Treasury issues a regular calendar schedule that sets a specific time each month that FNMA can issue its longer-term debentures. In addition, FNMA can borrow "off-calendar" with Treasury approval as long as it does not interfere with Treasury or other "agency" borrowers. According to FNMA, HUD, and Treasury officials, a mutually agreeable calendar schedule has been established, and approvals of off-calendar borrowing are generally routine. A noteable exception was Treasury disapproval of FNMA's request to issue bearer debt in offshore markets. (See pp. 103-104.)

RECOMMENDATIONS TO THE CONGRESS

FNMA's multiple links to the federal government expose the government to a potentially large but ill-defined financial risk. This arrangement was created on the premise that FNMA's operations would achieve public policy objectives.

GAO could not fully explore every aspect of HUD's regulatory and oversight performance in the time available. GAO believes, however, that the Department's performance has fallen short of what Congress envisioned in the Charter Act. Furthermore, FNMA's significant growth, its losses in recent years, and the level of risk which it must now take to continue operating were probably not anticipated in 1968. As a result, Congress may not always have had adequate information regarding FNMA's activities, and certain important regulatory and oversight functions may not have been performed, during a period when economic and legislative changes have buffeted the home lending business.

To improve the regulatory, oversight, and evaluation functions relative to FNMA, GAO recommends that Congress

--establish by legislation a permanent oversight function within HUD or some other federal regulatory entity that will monitor FNMA activities, evaluate how well it performs its public policy objectives, and periodically report to the Congress on these matters.

--clarify in legislation the regulatory role desired by Congress, particularly as regards aspects of FNMA's operations such as its portfolio operations which expose the federal government to financial risk.

In carrying out this review, GAO did not have legal access to all the information needed and had to rely on information provided voluntarily by FNMA. GAO therefore recommends that Congress provide it with the authority to audit FNMA's financial records and evaluate its programs and with the right to access all FNMA corporate records. This would allow GAO to be more responsive to the needs of Congress. (See pp. 109 and 117-118.)

AGENCY COMMENTS

FNMA comments

The corporation said that GAO had successfully identified the key issues relative to FNMA's operation. But FNMA suggested that GAO had downplayed certain of the benefits it provides while focusing on its earlier role in assisting low- and moderate-income households and providing countercyclical credit support. It states that its role has changed along with the mortgage market but it maintains that it still provides these earlier benefits as well as a wide variety of others.

FNMA said that GAO's recommendations, if improperly interpreted, could be used to argue for limiting the corporation's management flexibility. They acknowledged the need for FNMA oversight but suggested that HUD regulation should be performance oriented with the corporation periodically reviewed against public policy objectives. FNMA also said that GAO audit authority was inconsistent with the corporation's private business identity. (See pp. 118 and 133.)

GAO response

GAO analyzed a whole range of potential FNMA benefits, but emphasized the low- and moderate-income and countercyclical benefits in particular because these have been thought of as key to the corporation's public purpose.

As regards regulation and oversight, GAO did not suggest any particular federal role and certainly not one that would limit the corporation's ability to manage. For example, one appropriate role might be analagous to that of regulators of other financial institutions. Thrift institutions are free to manage within broad parameters to produce a profit, yet the riskiness of their loan portfolios is monitored in terms of both credit and interest rate risk. If necessary, financial regulators can require a thrift institution to modify its business activity to mitigate risk.

GAO's recommendation on audit authority is consistent with its long standing position that, except for entities GAO is required to audit by law, government sponsored or chartered corporations should be audited by independent private accountants, but that GAO should be empowered to review these audits and should have authority to access records and perform audits and evaluations of these corporations. (See p. 118.)

HUD comments

HUD said that the GAO report would be useful to the Department in completing its report on FNMA, and made three major points:

--HUD has concentrated on program approvals and their public implications, and has structured its oversight role to avoid duplicating the efforts of others, such as FNMA's independent auditors and the Treasury. The Department noted that some overlaps, such as exist between the FHLBB's supervisory responsibilities over thrifts and those of the thrifts' internal auditors may be necessary.

- --Given changes in the size and nature of FNMA's activities, it may be time to reconsider the government's regulation and oversight of FNMA as GAO suggests. In particular, Congress probably did not envision the risk to which FNMA now exposes the government, although monitoring this risk may be beyond HUD's capacity.

- --Despite HUD objections, Congress recently weakened its regulatory control over FNMA by voting to remove HUD approval of its debt and certain mortgage purchase programs.

HUD concludes that GAO indirectly raises a more basic question of whether the present level of FNMA benefits to society justifies its unique advantages. HUD believes this question is central to congressional re-examination of FNMA. (See p. 107-108 and 118-119.)

GAO response

GAO agreed in general with HUD's comments, including the observation that GAO's work raises the basic question of whether Congress should reconsider FNMA's public purpose role. GAO believes the information in its report provides a base on which the Congress could build if it were to do so. With respect to HUD's role GAO noted that:

- --HUD's evaluation efforts relative to FNMA's public purpose should not be confined to studying new FNMA programs, but should include a periodic look at all FNMA activities in terms of its contribution to public policy objectives.

- --Although HUD concludes that it probably does not have the capacity to act as a financial regulator or "watchdog" in evaluating FNMA's risks, this is nonetheless an important function. If HUD does not have, or cannot develop, this capability it could contract with another financial regulatory agency to perform this function.

- --Improved oversight, evaluation, and regulation as suggested by GAO would aid any Congressional re-examination of FNMA's role. (See pp. 108-109 and 119-120.)

The **Chairman**. I thank you very much for your testimony.

Let me ask Mr. Turnbull a question. Would it be fair to say, setting COSBI aside for a minute, that actually the administration would like to see the termination of the SBIC and MESBIC programs?

Mr. **Turnbull**. Mr. Chairman, I think the administration would like to see the Government-guaranteed aspects of those programs terminated at this time; yes.

The **Chairman**. Which, in effect, terminates the program.

Mr. **Turnbull**. It would remove all Federal intervention.

The **Chairman**. If that is the position of the administration—and you and I both know that it is; we have been around this track several times—obviously, it is not going to come behind that in a secondary effort and back an enterprise such as COSBI.

Ms. Wieseman, what, in essence—and I know you have covered this in your testimony in detail, but if you could just summarize—what, in essence, do you believe should be retained by the Inspector General's office vis-a-vis authority over the individual SBIC's in order to guarantee the public interest in a matter such as COSBI?

Ms. **Wieseman**. Well, first, Mr. Chairman, we believe that SBA should retain general regulatory authority over COSBI, that the Office of Inspector General have access to the audit reports of COSBI and all the small business investment companies, and access, also, to the work papers which support those audits.

We also believe that we should have the authority, as necessary and from time to time, to actually perform audits of the small business investment companies and the small business concerns.

We also believe that the investigative provisions of the Small Business Investment Act, which would be eliminated by virtue of COSBI, should be retained in order to give us investigative authority over COSBI and over the small business investment concerns that COSBI will be funding.

The **Chairman**. You know that a day does not go by, Mr. Turnbull, that I don't read in the newspapers, or I see on television, one mega-merger after another, and, indeed, all it is, is a shuffling around of moneys. It does not create any new jobs; it does not go ahead and create any innovation.

I'm going to tell you, and you can deliver this message back to the administration: I am more determined than ever, in light of these events of the past several years—and you know exactly the events I am talking about; they are not within your purview, but you read and you watch just as well as I do—the only protection left to the American people, in terms of lower prices and better quality and more jobs—the only protection left to the American people is that we will have a viable small business in this Nation, and the absolute key to that operation are the SBIC's.

I think it is absolutely frightening as to what is going on in terms of concentration of economic power among big business in the United States. And big business is fat, dumb, and happy, and nonproductive, and the only reason why these mergers are taking place is that they are just trying to save the corporate jobs at the top, period. It has nothing to do with product; it has nothing to do with jobs. And if ever there was a time—philosophically, if there ever was a time—for the administration to display its attitudes on competition in a free marketplace, it is now.

I just feel very, very strongly that the key to that is some loan programs in terms of starting small businesses, SBIC and MESBIC programs in terms of a partnership with the private sector.

I am not wedded to the Small Business Administration because I am chairman of this committee. I am wedded to the small business community, because I think it is the only force out there that can keep the game honest insofar as the entire economic structure is concerned.

I would like to submit statements by Senator Alan Dixon and Senator John Kerry, which statements will appear in the record as if given in person by the respective Senators.

[The prepared statements of Senators Dixon and Kerry follow:]

ALAN J. DIXON
ILLINOIS

United States Senate
WASHINGTON, DC 20510

AUGUST 7, 1986

STATEMENT BY SENATOR ALAN J. DIXON

SENATE COMMITTEE ON SMALL BUSINESS

COSBI LEGISLATION

MR. CHAIRMAN, I AM PLEASED TO PARTICIPATE IN TODAY'S HEARING WHICH IS DESIGNED TO EVALUATE THE MERITS OF ESTABLISHING A CORPORATION FOR SMALL BUSINESS INVESTMENT, OR COSBI. I WOULD ALSO LIKE TO COMMEND YOU AND THE RANKING DEMOCRAT ON THIS COMMITTEE, SENATOR BUMPERS, FOR INTRODUCING THIS LEGISLATION.

THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM, ESTABLISHED IN 1958, WAS DESIGNED TO MEET THE NEED OF SMALL BUSINESS TO GET ACCESS TO CAPITAL. BANKS AND OTHER CONVENTIONAL FINANCING SOURCES OFTEN DO NOT PROVIDE RISK CAPITAL TO SMALL FIRMS, AND PRIVATE VENTURE CAPITAL FUNDS SELECTIVELY INVEST IN A VERY NARROW RANGE OF COMPANIES WITH EXCEPTIONAL PROSPECTS FOR GROWTH. AS A RESULT, THERE IS A HUGE GAP BETWEEN THE SMALL BUSINESS SECTOR'S CRITICAL NEED FOR

LONG-TERM, GROWTH CAPITAL AND THE AVAILABILITY OF THIS TYPE OF FINANCING. SMALL BUSINESS INVESTMENT COMPANIES FILL THAT GAP.

THE SMALL BUSINESS INVESTMENT COMPANY INDUSTRY HAS BEEN A MAJOR SOURCE OF VENTURE CAPITAL FOR SMALL BUSINESS FOR MORE THAN 25 YEARS. OVER $5 BILLION HAS BEEN INVESTED IN OVER 66,000 SMALL GROWTH FIRMS DURING THE PAST QUARTER-CENTURY.

TODAY, OVER 500 COMPANIES, WITH ASSETS IN EXCESS OF $2 BILLION, ARE ACTIVELY ENGAGED IN THE FINANCING OF EMERGING GROWTH COMPANIES.

INDEPENDENT STUDIES PROVE THAT SBIC INVESTMENTS PRODUCE POSITIVE BENEFITS FOR THE AMERICAN ECONOMY. SBIC-FINANCED SMALL FIRMS HAD GROWTH RATES 10 TIMES THOSE OF OTHER SMALL COMPANIES IN SALES, PROFITS AND EMPLOYMENT, AND THEY PRODUCED NEW FEDERAL TAX REVENUES AT A RATE FIVE TIMES GREATER.

BY INVESTING IN SMALL GROWTH FIRMS THAT GENERATE JOBS, SBICS HAVE CREATED THOUSANDS OF NEW PERMANENT JOBS AT AN ACTUAL COST TO THE GOVERNMENT FOR EACH NEW JOB OF ONLY $312--A RESULT UNMATCHED BY ANY OTHER FEDERAL PROGRAM.

DESPITE ITS SUCCESSFUL 25 YEAR TRACK RECORD, THE SBIC PROGRAM FACES VERY SERIOUS PROBLEMS. IN ORDER TO PLAN, OPERATE AND INVEST EFFECTIVELY, SBICS NEED A RELIABLE SOURCE OF FUNDS AND A STABLE REGULATORY ENVIRONMENT. THE CURRENT

LEVERAGE AND REGULATORY PROCESS IS NO LONGER SERVING THE NEEDS OF SMALL BUSINESS OR THE SBIC INDUSTRY. CONTINUED UNCERTAINTIES OF ANNUAL CONGRESSIONAL FUNDING AND RESTRICTIVE ALLOCATIONS OF SCARCE DOLLARS HAVE MADE THE FINANCIAL PROCESS UNRELIABLE. IN ADDITION, CONTINUALLY CHANGING GOVERNMENT REGULATORY POLICIES HAVE CREATED AN UNRELAIBLE AND UNSTABLE OPERATING ATMOSPHERE WHICH IS COUNTERPRODUCTIVE TO SOUND INVESTMENT AND BUSINESS PRACTICES.

THE PROPOSAL BEFORE US ELIMINATES THE UNCERTAINTIES OF THE CONGRESSIONAL BUDGETARY PROCESS BY PROVIDING A MECHANISM FOR ACCESS TO PRIVATE CAPITAL MARKETS THROUGH THE NEW CONGRESSIONALLY-CHARTERED CORPORATION FOR SMALL BUSINESS INVESTMENT. THE CORPORATION WILL SELL ITS SECURITIES TO PRIVATE INVESTORS AND REINVEST THE PROCEEDS IN SBICS, PROVIDING THE SBIC INDUSTRY A STABLE FLOW OF CAPITAL FOR INVESTMENT IN SMALL FIRMS.

SOME OF THE QUESTIONS CONCERNING THIS CORPORATION, WHICH WE HOPE TO GET ANSWERED TODAY, CONCERN THE LEVEL OF BUDGET SAVINGS THAT THE FEDERAL GOVERNMENT WOULD INCUR THROUGH THE FORMATION OF COSBI, THE PROBABILITY OF COSBI SUCCEEDING IN THE PRIVATE MARKET AND THE LEVEL OF REGULATORY AUTHORITY NECESSARY TO INSURE THAT COSBI WILL CARRY OUT THE PUBLIC PURPOSE OBJECTIVES BEHIND THE PROGRAM.

MR. CHAIRMAN, I LOOK FORWARD TO EXPLORING THIS SUBJECT DURING TODAY'S HEARING.

STATEMENT OF SENATOR JOHN KERRY ON THE PROPOSAL TO CREATE A SMALL BUSINESS INVESTMENT CORPORATION

THANK YOU MR. CHAIRMAN. THE PROPOSAL BEFORE US TODAY, TO CREATE AN INDEPENDENT CORPORATION FOR SMALL BUSINESS INVESTMENT--COSBI--IS AN IMPORTANT AND TIMELY RESPONSE TO THE GROWING DEMAND FOR CAPITAL BY SMALL START-UP COMPANIES. THE ALMOST CERTAIN LOSS OF THE CAPITAL GAINS PREFERENCE IN THE CURRENT TAX REFORM EFFORT MEANS THAT NEW BUSINESS FORMATIONS IN THIS COUNTRY ARE JEOPARDIZED UNLESS ENSURED OTHER MEANS TO SUPPORT RISK-TAKING AND CAPITAL FORMATION.

FORTUNATELY, WE HAVE SUCH A MEANS IN THE ENORMOUSLY SUCCESSFUL SMALL BUSINESS INVESTMENT COMPANY PROGRAM, AND THE MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT PROGRAM. ALTHOUGH THE REAGAN ADMINISTRATION HAS REPEATEDLY CALLED FOR ELIMINATION OF THIS PROGRAM AS A GIVE-AWAY TO BUSINESS, THE FACTS SHOW THAT THE SBIC PROGRAM IS WELL-CONCEIVED AND WELL-IMPLEMENTED -- A MODEL OF PUBLIC-PRIVATE PARTNERSHIP -- AND THAT IT CONTRIBUTES MANY TIMES ITS COSTS TO THE FEDERAL TREASURY AND THE AMERICAN ECONOMY IN NEW JOBS CREATED, NEW PRODUCTS, NEW EXPORTS, AND ADDITIONAL TAX REVENUES. COMPANIES LIKE APPLE COMPUTER, FEDERAL EXPRESS, NIKE AND PANDICK PRESS ALL ARE EXAMPLES OF SUCCESSFUL COMPANIES THAT NEEDED SBIC FINANCING TO GET OFF THE GROUND.

IF THE PROGRAM IS SO SUCCESSFUL, ONE MIGHT ASK, WHY CHANGE IT AT ALL? THERE IS A SOUND REASON FOR DOING SO IN THIS CASE, AND THAT IS BECAUSE THE CURRENT BUDGET ENVIRONMENT -- COMBINED WITH AN ADMINISTRATION THAT IS TRYING TO DESTROY NOT JUST THE SBIC AND MESBIC PROGRAMS BUT THE ENTIRE SBA -- CALL FOR CREATIVE SOLUTIONS THAT WILL ALLOW CONTINUED PROGRAM GROWTH AND OPERATIONAL STABILITY.

BY RETAINING THE SUCCESSFUL ASPECTS OF THE SBIC PROGRAM -- CONCERNING THE OPERATION OF THE SBICS THEMSELVES AND THEIR RELATIONSHIP TO THE COMPANIES IN WHICH THEY INVEST -- WHILE CHANGING THE NATURE OF THE FINANCING TO TAKE THE PROGRAM OFF BUDGET, WE CAN ACOMPLISH OUR OBJECTIVES.

MY ONLY CONCERN IS THAT WHILE WE DO THIS, WE ENSURE APPROPRIATE OVERSIGHT AUTHORITY FOR THE SBA OVER THE ENTIRE PROGRAM, NOT ONLY THE COSBI ITSELF BUT OVER THE SBICS AND MESBICS AS WELL. I HOPE THESE ISSUES CAN BE RESOLVED TO THE SATISFACTION OF ALL PARTIES, AND THE BILL CAN BE PASSED THIS YEAR.

Mr. **Turnbull**. Thank you, Mr. Chairman.

Ms. **Wieseman**. Thank you.

The **Chairman**. Our next panel consists of Mr. Thomas Noojin, president and chairman, Hickory Venture Capital Corp., of Huntsville, AL, and Mr. Noojin is representing the National Association of Small Business Investment Companies. We welcome him to this hearing.

We also have with us today Mr. Herbert Wilkins, who is the president of SYNCOM Capital Corp., of Washington, DC. He is representing the American Association of MESBIC's. And we welcome Mr. Wilkins to our committee.

Why don't we proceed in the order which I have indicated, which means that Mr. Noojin will testify first.

I might say that all statements in their entirety will be placed in the record, and so you might want to, in some way, do some synopsizing of those statements in order that we can have a little back and forth here in terms of questions which might fill out the record in a better way.

STATEMENT OF J. THOMAS NOOJIN, CHAIRMAN AND PRESIDENT, HICKORY VENTURE CAPITAL CORP., HUNTSVILLE, AL, REPRESENTING THE NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. **Noojin**. Thank you, Mr. Chairman. I appreciate being invited to testify, and also our industry appreciates your strong sponsorship of both the SBA and SBIC Programs over the years.

I would also like to state that this legislation has been proposed and developed jointly with your staff and between NASBIC and AAMESBIC in a joint venture. We feel that it is vitally necessary for the continuation of the program.

Your introductory comments made it somewhat clear as to why this legislation is necessary. Your comments at the end of the program relative to small business, we think, are the very essence for our being here.

SBIC's and MESBIC's have invested more than $6 billion in over 70,000 small growth firms in its existence. Over 3,500 firms were financed by both entities in 1985 alone, and we have assets of some $2 billion.

Something that gets lost from time to time in this process is the fact that SBIC's and MESBIC's have approximately $1.4 billion in private capital injected into these companies. This private capital was put into these companies over the last 26 years on the premise that the SBIC Program, which was founded to promote long-term financing for the small business sector of our economy, would be there.

During the last few years, however, we have had significant problems with, No. 1, rationalizing that our existence was going to be, and we have also had a number of other difficulties.

I would like to emphasize that small business is the name of the game. There have been many studies that have been released that have indicated that small business creates over 80 percent of the new jobs in this country.

Arthur D. Little and Haskins & Sells have estimated, in a 10-year study of the record of our industry, that we created over 926,000 jobs, conservatively, in a 10-year period.

Also, as you know, most of the innovations come from small business. Cray Research, who testified before your committee last year, the leading manufacturer of super computers and the worldwide leader in those computers, testified they had paid more in taxes than the entire SBIC Program had cost the Government in its 26 years of existence.

Cray Research is merely one company that has come out of this particular industry. There are others, like Federal Express Corp., $3.5 billion in revenues, 20,000 employees; Rohm Digital Switch; and any number of others that have been the so-called glamorous companies that have come out of our industry.

Despite this track record, in 1981, the administration appointed an SBA Administrator, who, without notice to the industry, stopped licensing new industries and cut off the lifeblood of the industry which was leveraged from the SBA.

That only lasted a few months, fortunately, and in no small part to the efforts of this committee. Beyond that, however, we have had budget freezes, retirements, and assumption of program control by individuals with no line experience which have produced a series of setbacks this industry has yet to recover from.

When leverage was restored in 1981, for example, the SBA established credit criteria for a theoretical allocation process which happened to fly in the face of 23 years of precedent. The original version of the SBA's overhaul of the SBIC regulations would have devastated this industry; a forced investment diversification by SIC code determining what SBIC should invest in, and any number of specific items that fly in the face of the free enterprise approach in this Government private partnership that we have conducted our business on for the last 26 years.

Let's don't forget the most recent SBA Administrator, who came with a mandate that he did not intend to implement the new funding system authorized by the Budget Reconciliation Act until this committee intervened.

All this is to say that because SBIC's are in the business of making long-term investments, they need a reliable partner for a long-term environment, with long-term stability.

The current leverage and regulatory process is no longer serving the needs of small business or the SBIC industry. Indeed, we have not had leverage for the last 5 months.

Finally, I would like to say that the COSBI concept of privatizing the SBIC Program was generated in Congress. In 1967, the Congress added a provision to the Small Business Act of 1958 which specifically requires SBA to make recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies.

We think the COSBI legislation does that.

I know that you are familiar with the history and some of the points of the COSBI legislation, so I would like to briefly address some of the issues that have been raised by the SBA.

There are generally five areas in the current regulations that are considered to be policy issues. We believe the COSBI legislation has codified those areas and addresses the specific issues. For example, this legislation provides that SBIC's or COSBI members would only be permitted to invest in small businesses as defined by the law, which is the current definition.

SBIC's cannot control companies as in the existing law. SBIC's are required to diversify, thereby protecting their credit position. There are prohibited transactions that are not consistent with the act or the law or intent of Congress, and obviously there is no self-dealing or conflicts-of-interest permitted in the regulations.

As to the issue of oversight, we feel that by privatizing the SBIC industry, that the 15-member board of directors, 5 of whom are appointed by the President of the United States, 10 of whom are elected by the stockholders of COSBI, will have a tremendous incentive for oversight of the process—that incentive, and the most compelling reason being market forces. If the integrity of these securities is not protected, the market will not accept the securities, and, therefore, the whole effect of COSBI will be null and void.

COSBI will have a contract with SBIC's which will spell out the aforementioned codified regulations, contain certain other regulatory and reporting rules which we believe will be enhanced over the existing methods, and will require compliance under threat of accelerating repayment of leverage and removal of licensee.

In short, we will be shifting the regulatory burden to COSBI, and we will have the civil courts as our principal enforcement. However, I would like to point out that the legislation does provide that in cases of criminal action, just as the SBA currently does, COSBI will be allowed to refer for investigation to the Justice Department.

With regard to the Inspector General's testimony, I would simply like to say that some of the things that are being asked for in that testimony give the Inspector General greater powers than they currently have, and, because we did not have time to study this testimony prior, we are not prepared to comment item-by-item. We would be glad to work with your staff, and intend to work with your staff on ironing out those issues as well.

Last, as to the issue of privatization, I think it is important to differentiate between the existing situation and what COSBI will have.

First of all, Congress has already expressed its intent to authorize $250 million a year for SBIC's for the next two years. We are all familiar with the S. 408 negotiations. We are all familiar with the budget recommendation for SBA that came out recently, in the first part of this year, and we are all familiar with the fact that the administration probably will not honor the 3-year implied or specific agreement that they had relative to these allocations, SBIC budget allocations.

However, with the stated intent of Congress, there are currently about $1.6 billion of obligations, guaranteed obligations, either in force or stated that they will be issued, that is, $250 million for 2 additional years. Between 6 and 10 years, we anticipate that this obligation will only be totally gone; that there will be a $500 million backstop, implied backstop remaining.

Unlike FNMA and SLMA, this backstop has to be specifically appropriated by Congress. It is not a backstop that can be called upon without justification or without accountability. So, we think within 6 to 10 years, we will have eliminated over $1 billion in existing Government exposure. In addition, we will put the industry in a do-or-die situation.

We will either maintain the credibility and integrity of the industry, or it will not exist.

In any case, there will be no continuing obligations on the part of the Small Business Administration's budget resources, and we think that the market forces will make oversight much more efficient than the SBA thinks at the present time.

As to SBA oversight, we feel that the SBA has an oversight position in the existing legislation. They have the right to audit COSBI's records; they have the right to look over the shoulder of COSBI; they have the right to report to this committee, the Treasury Department, the House Small Business Committee, and report anything that they see out of line.

Indeed, there is some sentiment that SBA maintains too much oversight in the situation. On the other hand, the industry is certainly willing to give the SBA its continuing participation and knows that we can work with them toward a constructive relationship.

I am going to conclude my remarks, Senator, at this time.

[The prepared statement of Mr. Noojin follows:]

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August 7, 1986

STATEMENT OF
J. THOMAS NOOJIN

before the

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Thomas Noojin, Chairman and President of Hickory Venture Capital Corp. which is located in Huntsville, Alabama. Hickory was organized in March of 1985 as a subsidiary of First Tennessee Bank of Memphis, and capitalized at $4 million. For the ten years prior to joining Hickory, I was chief executive officer of Invesat Capital Corporation, an SBIC in Jackson, Mississippi. During this year I am also serving as Chairman of the National Association of Small Business Investment Companies (NASBIC), which represents the overwhelming majority of all licensed Small Business Investment Companies (SBICs).

We very much appreciate your introduction of S. 2647, the proposed legislation to create the Corporation for Small Business Investment (COSBI). We also appreciate your expeditious scheduling of this historic hearing on the COSBI proposal and the opportunity you have given us to testify on this important legislation.

INTRODUCTORY COMMENTS

At the outset, I would like to make it very clear to the Committee that the COSBI proposal has been developed through a joint-venture between the MESBIC industry and the SBIC industry. This effort has been a true partnership between the American Association of MESBICs and NASBIC, in terms of the time, effort, creativity and resources devoted to the development of COSBI. Both organizations fully support this legislation, and I am delighted and honored to have Herbert Wilkins, the Legislative Chairman of AAMESBIC, as my fellow witness at this hearing.

The COSBI bill is a lengthy and complex piece of legislation and your letter of invitation to testify raised a series of specific questions about COSBI. Accordingly, my testimony today will address those questions and concentrate on five primary items: (1) why we believe COSBI is necessary; (2) the basic concepts of COSBI and how it will work; (3) the benefits COSBI will provide; (4) the key issues in the legislation; and (5) the major improvements that have been made in the bill from the previous version of the bill S. 2686, which was introduced in the Senate in the last Congress. Mr. Wilkins will cover several of these points from the special perspective of the MESBIC industry. Most importantly, he will discuss the special interrelationship of COSBI and the MESBIC Trust.

WHY COSBI IS NECESSARY

We are proud of the SBIC industry's track record. Our industry has been a major source of venture capital for small business for more than 26 years. SBICs and MESBICs have invested more than $6 billion in over 70,000 small growth firms. In 1985 alone, SBICs made 2,756 investments in a wide variety of small growth companies in geographically diverse sections of the country; while MESBICs financed 1,262 minority-owned small businesses. Today, over 500 SBICs and MESBICs, with assets in excess of $2 billion, are actively engaged in the financing of thousands of small, job-creating growth companies. We conservatively estimate that SBICs have created over 900,000 new jobs during the life of the program.

Despite this successful record, however, the SBIC program has reached a critical crossroads. Let me explain why by giving you a brief review of the industry's recent history.

In retrospect, the 1970s were a dynamic 10 years for SBICs. The industry's energy was primarily devoted to many positive improvements in the program, including such things as increased leverage, improved compensation plans for SBIC managers, size standard liberalization, limited partnership SBICs and, of course, an effective system of financing through the Federal Financing Bank (FFB). SBA's Investment Division staff was generally comprised of experienced individuals and the regulatory environment for the most part, embodied a "let's make it work" approach. I am not suggesting that the 70's were without problems, but the combination of willingness to compromise and leverage availability allowed the industry to undertake its intended mission with a high degree of success.

The industry was on a roll. SBIC assets at cost which had been $633 million in 1970 reached $1.4 billion by 1980. During the decade, the capital gains tax differential had been restored, ERISA had been liberalized to open up pension and other institutional investments in the industry, the economy was beginning to recover from the shock of oil price increases and the number of SBICs and MESBICs was dramatically increasing. In addition, Genentech hit the street with a public offering signaling the beginning phases of another euphoric IPO market. The stage was set. A pro-business, pro-entrepreneur, pro-capital formation, no-tax-increase President had just been elected. What could go wrong?

Unfortunately, the trends established in the 70's did not carry forward into the new decade. The temper of this industry's steel has never been tested as it has during the 80's. At a time when we were poised to continue our leadership position in the venture industry, the Administration took away our momentum by stopping leverage and licensing without warning.

In addition, a series of SBA policies initiated during 1981 and 1982 reverberated throughout the industry. Budget freezes, retirements and assumption of program control by individuals with no line experience produced a series of setbacks the industry has yet to recover from. To list a few: when leverage was restored, the SBA established credit criteria for a theoretical allocation process which happened to fly in the face of 23 years of precedent; the original version of SBA's overhaul of the SBIC regulations would have devasted the industry; questionable policies prohibiting investments in small operating companies in the oil and gas business; a mandatory equity proposal requiring every SBIC to have investments in straight equity as a percentage of their portfolio; operating agreements for equity-oriented SBICs before they could get leverage, if they could get it at all; a forced investment diversification proposal by SIC code, and there are others. Most of these policies were implemented or initiated without any discussion with the industry, and obviously without any consideration of the operating implications.

Finally, as the ultimate insult to the success of the SBIC program, for the past two years the Administration has proposed that the program be terminated. The Administration has proposed a complete shut-down of this valuable source of risk capital for small business. But, this proposal was made not based upon any measured evaluation of the program. Indeed, in this very hearing room last year we saw a tape of President Reagan applauding the significant contributions of the SBIC program to the nation as a whole and to small business in particular. He recognized that "SBICs and MESBICs have been pioneers of private sector/government efforts to expand the availability of venture capital for small business" and that we have "proven that public/private partnership can do things that government alone cannot accomplish." Yet, despite our incredible track record of accomplishments over the years, the SBIC and MESBIC programs were still put on the chopping block!!

More recently, Congress felt obliged to take the SBIC program out of the FFB system in order to achieve budget savings. To make matters worse, for several months it was quite apparent the new SBA Administrator did not intend to implement the new funding system authorized by the Budget Reconciliation Act. It was only in response to substantial pressure by this Committee that he reluctantly agreed to put the new system in operation. I should note that as a result of those events the SBIC industry has been at a dry well, without a source of funds, for the past five months.

Buffeted by these threats to close down the program, destabilizing policies and uncertain access to leverage, we have concluded, as prudent business men and women, that it is absolutely essential to privatize the SBIC program and bring stability and predictability to our industry.

In the face of indisputable success, we are still subject to blind-side, killing blows from SBA, the Administration and even Congress. It is time to alleviate the financial and regulatory uncertainty that makes it impossible to plan our future and protect our capital investments.

In short, because SBICs are in the business of making long-term investments, they need a reliable partner for the long haul. In order to plan, operate and invest effectively, SBICs need a reliable source of long-term funds and a regulatory environment with long-term stability. The current leverage and regulatory process is no longer serving the needs of small business or the SBIC industry. Continued uncertainties of annual Congressional funding and restrictive allocations of scarce dollars have made the current financial-support process unreliable. In addition, continually changing government regulatory policies have created an unreliable and unstable operating atmosphere, which is counterproductive to the business of long-term investing.

Let me point out that our options are very limited. Unless we have a creative vehicle like COSBI, the SBIC industry's future is in jeopardy.

SBICs must have access to the capital markets through a financial intermediary that is responsive to the unique needs of small business investment companies. COSBI will give SBICs that facility.

Finally, let me add that credit for the concept of privatizing the SBIC program should be given to the Congress. In 1967, with great wisdom and foresight, the Congress added a provision to the Small Business Investment Act of 1958 which specifically requires SBA to make:

> ". . recommendations with respect to the feasibility and organization of a small business capital bank to encourage private financing of small business investment companies . . ."

It's ironic that after a period of nineteen years in which SBA failed to make a single constructive recommendation on privatization, the SBIC industry is stepping forward with a specific proposal to carry out the intent of Congress, and the SBA is waging war against the idea.

COSBI -- IN SUMMARY

I will review the basic features of COSBI. (The terms "COSBI" and "Corporation" are used interchangably.)

The Concept

COSBI will be a privately owned and managed, special-purpose financial institution, created by an Act of Congress. Its primary mission will be to provide long-term financing and an effective operating environment for SBICs.

COSBI will operate as a "capital bank," providing SBICs access to a stable source of leverage. Because of its special status as a government-sponsored enterprise, COSBI will be able to sell its securities in the capital markets at highly competitive yields. In turn, COSBI will be able to provide leverage to the SBIC industry on terms which are attractive and structured to meet the unique financial needs of SBICs. This assured source of affordable capital will increase the SBIC industry's capacity to make continued venture capital investments in small growth firms.

In addition, COSBI will exercise oversight of SBIC business practices through a streamlined process that is fair and efficient. COSBI's Board and management will respect the SBIC manager's need for long-term policy continuity. This operating environment will be a significant improvement over the current process of government intervention in SBIC investment activities.

The Benefits

We are confident that COSBI, operating within the risk-reward system of the private marketplace, will generate enormous benefits for the economy in several ways.

Small business will be the primary beneficiary. COSBI will provide small business access to the major capital markets, and we are convinced that COSBI will, in just a few years, increase the flow of venture capital to small firms by hundreds of millions of dollars, perhaps billions.

Because small business is the major job creator and innovator in the American economy, increased venture investments flowing through the new system will create hundreds of thousands of new jobs in a wide variety of industries and thousands of product innovations, technologies and new commercial applications.

We are also convinced that the creation of COSBI will produce a substantial reduction in the Federal budget deficit. The Government will also benefit by the eliminaion of SBA's complex financial and regulatory apparatus and its accompanying payroll.

In addition, millions of dollars in new tax revenues will be produced by the capital formation multiplier effect of new investments in the economy.

Finally, this country's venture capital system will be greatly enhanced by conversion of the SBIC program to a fully private system. COSBI will provide a new investment climate that will attract hundreds of millions of dollars of new private capital into the SBIC program.

MAJOR FEATURES OF THE COSBI CONCEPT

Agency Status

COSBI will be a privately-owned and managed corporation. In addition, because COSBI will be provided several indicia of government support, it will be considered a government-sponsored enterprise, or "agency". This unique status is similar to that of the Student Loan Marketing Association (SLMA), the Federal

National Mortgage Association (FNMA) and several other privately-owned corporations supported by the Federal government. Because of this government sponsorship, the securities which COSBI issues in the capital markets will receive market acceptance as federal agency securities, enabling COSBI to obtain favorable interest rates on the funds it borrows. Among the features of government sponsorship provided in the COSBI Bill are the following:

1. **Created by an Act of Congress**

COSBI will be a privately-owned and managed corporate instrumentality of the United States, created by an Act of Congress. The principal office of COSBI will be located in Washington, D.C.

2. **Public Representation on the Board of Directors**

Initially, the President of the United States will appoint an interim five member Board of Directors. The main function of the interim Board will be to arrange for the initial subscription offering of common stock of COSBI and to take whatever other actions are necessary to proceed with the operation of the Corporation. After $15 million of common stock of COSBI has been purchased, the stockholders will then elect ten members of the Board of Directors. The remaining five will be appointed by the President.

3. **Exemption from Securities Registration**

The common stock and other securities issued by COSBI will be ~~deemed to be~~ "exempted securities" under the laws administered by the Securities and Exchange Commission, to the same extent as securities which are direct obligations of, or obligations guaranteed as to principal and interest, by the United States Government. No registration statement or other documents with respect to the common stock or other securities issued by COSBI will be required to be filed with the Securities and Exchange Commission.

4. Exemption from State and Local Taxes

COSBI will be exempt from all taxation by any state or by any county, municipal or local tax authority except for real property taxes. COSBI will not be exempt from the payment of Federal corporate income tax.

5. Exemption from State "Doing Business" Qualifications

COSBI will be able to conduct its business without regard to any "doing business" qualification statutes in any state of the United States, including the District of Columbia, the Commonwealth of Puerto Rico and the territories and possessions of the United States.

6. COSBI Stock Eligible for Purchase by Depository Institutions

Federally regulated depository institutions will be authorized to make capital contributions to COSBI, and to receive either common or preferred stock evidencing their contributions.

7. COSBI Obligations Acceptable as Collateral for Public Funds

COSBI will be deemed to be an agency of the United States for certain investment purposes, and obligations issued by COSBI will be lawful investments acceptable as security for all fiduciary, trust and public funds under the authority or control of the United States. With this status, the obligations of COSBI will be considered liquid investments which can be used to satisfy reserve requirements of banks and savings and loan associations.

Organization And Management

1. Interim Board

Upon enactment of the COSBI Bill, the President of the United States will appoint an interim Board of Directors, consisting of five members, one of whom will be designated by the President as interim Chairman. Of the five members, two will be representative of small business, two will be representative of SBICs and one will be the SBA Administrator. The main function of the interim Board will be to arrange for the initial subscription offering of COSBI's common stock and to take other actions necessary to proceed with the organization of the Corporation.

2. **Board of Directors**

After the initial $15 million of common stock has been purchased, COSBI will be managed by a fifteen member Board of Directors. The holders of common stock will be entitled to elect ten members of the Board. The remaining five members will be appointed by the President. One of the five Board members appointed by the President will be representative of MESBICs, and two others will be representative of small business.

3. **Powers of the Board**

The Board of Directors will have the responsibility for determining the Corporation's general business, investment and operating policies. Directors of COSBI will not be considered employees of the Federal Government. The organizers of COSBI anticipate the elected members of COSBI's Board will be experienced SBIC professionals who, as leaders in the industry, will provide balanced representation for all SBICs, regardless of size or investment policy.

4. **Officers and Staff**

The Board of Directors will also appoint, establish compensation for, and prescribe the functions, powers and duties of the executive officers selected to manage the day-to-day business operations of COSBI. Officers and staff of COSBI will not be considered employees of the Federal government. The organizers of COSBI expect that the executive officers selected to manage the Corporation will be qualified individuals who are familiar with the venture capital business and the SBIC industry in particular.

5. **Internal Operations and Controls**

While the Corporation's specific organizational structure has not been determined, COSBI will be operated as a streamlined, efficient and cost-conscious business organization. In addition, COSBI's management will establish internal systems necessary to the sound operation of a well managed financial institution. These will include audit and finance committees of the Board, internal finance and budgetary control systems, and automated accounting and data systems.

Capital Structure

1. **Initial Capitalization -- Stock Offering to SBICs**

Following enactment of the COSBI Bill, the Corporation will undertake a common stock offering to raise a minimum of $15 million. SBICs will be offered the right to subscribe, at a subscription price to be determined, a total number of shares of common stock on the basis of 2% of the aggregate private capital of the SBIC industry. Accordingly, each SBIC will be offered the right to subscribe a minimum number of shares of common stock on the basis of 2% of its private capital.

2. **Use of Proceeds**

Proceeds from the proposed subscription of COSBI common stock will be used to provide an equity base to support COSBI's borrowing activities, to provide working capital for COSBI and to carry out general corporate purposes.

3. **Other Sources of Capital**

COSBI will have access to additional capital based on growth in the SBIC industry. This includes capital contributions by newly-organized SBICs, and supplemental capital contributions from operating SBICs based on increases in their private capital. In addition, the COSBI bill authorizes the purchase of

COSBI's preferred stock by federal depository institutions, and the public sale of non-voting stock. The Corporation's decision to utilize these sources of capital external to the SBIC industry will be based on COSBI's performance, market conditions and other factors.

4. **Purchase of the FFB Portfolio of SBIC Debentures**

In order to provide COSBI with an initial asset base of sufficient size to gain recognition in the capital markets, the COSBI Bill provides for the sale to COSBI of the portfolio of SBA-guaranteed SBIC debentures held by FFB. The transfer would be made on terms designed to permit COSBI to be self-sustaining and financially sound. The FFB holds slightly over $1.0 billion of SBIC securities guaranteed by SBA. COSBI would finance the purchase of this portfolio through the issuance of debt securities in the capital markets.

5. **"Backstop" of the United States Treasury**

The COSBI Bill provides that the Secretary of the Treasury, subject to funds being appropriated by Congress, is authorized to purchase up to $500 million of obligations issued by COSBI. This authority is similar to Treasury support provided to FNMA, SLMA and other government sponsored enterprises. It is an essential factor in assuring that COSBI's debt instruments achieve market acceptance as federal agency securities, enabling COSBI to obtain favorable interest rates on those securities. This authority is intended solely as a last-resort source of funds for COSBI, and would be available only if Congress determined they were absolutely necessary.

Financial Operations

COSBI will serve as a secondary market and warehousing facility for loans and investments in SBICs; will provide liquidity for loans and investments in small business; will stimulate the orderly flow of private equity capital and long-term loan funds to small business; and will improve the distribution of investment capital available for small business concerns.

1. **Financing SBICs**

The principal activity of COSBI will consist of the purchase of securities from SBICs meeting certain eligibility requirements established by the Corporation. The organizers of COSBI fully anticipate the Board of Directors will establish a basic policy that every SBIC, regardless of its size or investment policy, will be eligible for leverage if the SBIC's financial condition meets certain minimum qualification standards set by COSBI, and applied universally to all SBICs.

It is expected that for some initial period of time COSBI will continue to finance SBICs through the purchase of long-term, fixed rate securities similar to those currently issued through the FFB leverage system. Under the COSBI Bill, the Corporation will have authority to finance SBICs through a variety of sophisticated financial instruments which might more appropriately match the specific liquidity needs of SBICs. Once COSBI's positive performance record has been shown, its financial condition firmly established and the Corporation's securities have gained acceptance in the capital markets, COSBI will broaden its program options and develop customized financial products to meet unique industry requirements.

2. **COSBI Indebtedness**

The investment activities of COSBI will be financed by funds raised in the capital markets primarily through the issuance and sale of debt securities. COSBI's debt securities will have market acceptance as Federal agency securities, a category of investments well publicized and known to informed investors. This acceptance will enable COSBI to obtain a favorable rate of interest on offerings of its obligations. Notwithstanding their acceptance as Federal agency securities, COSBI's debt securities will not be obligations of the Federal government and will not be guaranteed by the Federal government.

COSBI may offer a variety of obligations, including longer-maturity debentures, intermediate-range debentures and short-term commercial paper, depending on the Corporation's financial plans and needs. The debentures and shorter term notes of COSBI will be issued regularly and will be general obligations of the Corporation. COSBI will also have authority to issue subordinated capital debentures, which would be general obligations of the Corporation with no stock conversion provisions. COSBI is also authorized to guaranty securities based on or secured by pools or trusts of SBIC securities eligible for purchase by COSBI. The Corporation could be either the issuer of such pass-through securities or act as a guarantor of such securities issued by SBICs. COSBI may also secure lines of credit through commercial banks which will enable the Corporation to satisfy short-term borrowing needs, as necessary.

Business Practices Of SBICs

Under the COSBI Bill, the Corporation is authorized to establish standards of business conduct for SBICs. COSBI will establish standards of eligibility for newly-organized SBICs to do business with the Corporation and standards of business practice for operating SBICs.

1. Qualification Standards

All SBICs in good standing with SBA at the time the Corporation commences operations will automatically be eligible to purchase stock in COSBI and participate in the new program. For newly-organized SBICs, the COSBI Bill authorizes the Corporation to establish qualification standards to do business with COSBI. Several factors to be included in these standards are specified in the COSBI Bill, including: the business reputation and character of the SBIC's owners and managers, the probability of its success, adequate capitalization and qualified management.

The COSBI Bill also specifically continues existing authority which permits the purchase of ownership interests in SBICs by commercial banks, up to an aggregate of five percent of the bank's capital and surplus. This authorization continues the current exemption for bank-owned SBICs from the Glass-Steagall Act.

2. Operating Standards

COSBI will establish standards for sound operating business practices of SBICs. These standards will include generally accepted operating and reporting requirements expected by creditors in conventional commercial practice. In addition, certain activities will be specifically prohibited or restricted by the COSBI Bill. These include, among others: the prohibition of conflict-of-interest transactions; a requirement that SBICs finance only qualified small businesses; a limitation on the dollar amount of an SBIC's investment in any one small firm, based on a percentage of the SBIC's private capital; and a limitation on an SBIC's ability to exercise control over any small business it finances.

3. Enforcement of Operating Standards

The SBIC operating standards will be set forth in contractual agreements between COSBI and the SBICs. Failure of an SBIC to adhere to those criteria will subject the SBIC to suspension or revocation of its qualification to conduct business with COSBI or other appropriate legal action. The contractual agreements will also establish a process by which COSBI will exercise oversight of an SBIC's business practices. This process will be far more efficient than the current SBA regulatory system. It will include audits, certifications of compliance by independent CPA firms, a timely review of financial reports, civil litigation where necessary, and referals to the Justice

Department in cases involving possible criminal activities. Such a system will be substantially better and more efficient than the one currently administered by the office of the Inspector General which recently concluded in a memo that it "can no longer perform the annual examination function of the SBIC program without neglecting the other audit responsibilities which we have under the Inspector General Act."

Oversight Of COSBI

As a government sponsored enterprise, COSBI's business and financial performance will be subject to several forms of review. These oversight features supplement representation on the Corporation's Board of Directors by the five Presidential appointees to the Board.

SBA will have specific authority to review COSBI's operations to assure the public purposes of the legislation are carried out. To carry out this responsibility, SBA will have access to the Corporation's books and records.

The accounts of COSBI will be audited annually by an independent certified public accountant, and the audit report will be furnished annually to the Secretary of the Treasury, who will have open access to the books and records of the Corporation. In turn, the Secretary of the Treasury will deliver a report of each fiscal year audit of COSBI to the President and the Small Business Committees of the Congress. COSBI will also be required, at the end of each fiscal year, to transmit to the President, the Small Business Committees of the Congress and the SBA Administrator, a report of its operations and activities for each year.

In addition, the COSBI Bill provides that the Corporation will be subject to audit by the General Accounting Office of the Congress at the request of either of the Small Business Committees of the Congress, as long as COSBI holds SBA-guaranteed debentures acquired from FFB. Finally, the Small Business Committees of the Congress will retain inherent oversight authority over COSBI as a government supported corporation established under legislative authority of the Small Business Investment Act of 1958.

BUSINESS STRATEGY FOR COSBI

While COSBI's Board of Directors will have the ultimate authority and responsibility to determine the corporation's investment and operating policies, the organizers of COSBI have developed several key elements of a business strategy for COSBI which they anticipate will be adopted by the Board.

Employ Sound Business Principles

As a for-profit corporation, COSBI's operations should be guided by sound business and financial principles. To successfully fulfill its primary mission as an efficient financial intermediary between SBICs and the capital and money markets, COSBI must develop and maintain the confidence of the financial community while providing essential financial services to the SBIC industry.

Build a Strong Financial Position

The primary emphasis of COSBI as a newly organized company should be that of building a sound financial base and a reasonable level of profitability. At the same time, COSBI must provide for reasonable growth in activity levels and the development of sufficient services to meet the liquidity needs of SBICs. In short, COSBI's management should exert every effort to build a strong balance sheet and a strong profit and loss statement.

Accordingly, management must undertake a disciplined approach to building COSBI's capital base. This should include a policy to capitalize retained earnings with no dividend distributions for some initial period of time, as well as positive actions to obtain additional capital from external sources. Sources of additional capital would include: capital contributions by new SBICs; supplemental capital contributions resulting from increases in the private capital base of SBICs; capital contributions from other types of financial institutions; and the possible future public sale of COSBI stock.

Minimize Exposure to Risk

Management must exercise care in structuring the terms of its assets and liabilities to reduce COSBI's exposure to future volatility in the bond and money markets. To the extent that COSBI acts as a lending principal, it should place continued stress on obtaining longer maturities at attractive rates, maximize the match between the maturities of its assets and liabilities and minimize short-term borrowings.

Reasonable Pricing to SBICs

In providing financial and business practice services to SBICs, the effective cost to SBICs for such services should be kept as low as possible, to the extent that goal coincides with COSBI's profitability objectives. This will require a reasonable approach to current income items such as rate spreads, fees and miscellaneous charges.

Cost Control

COSBI should be operated as a disciplined, cost-conscious corporation. This will require the implementation of a system of controls and procedures designed to enhance efficiency and cost control.

Measured Approach to Product Expansion

COSBI should take a measured approach to expanding its menu of products. It may be appropriate for the first several years to continue financing SBICs through the familiar medium of long-term, fixed-rate securities. Once COSBI has established a firm financial base and has gained clear recognition in the capital markets, it can broaden its program options and develop tailored products to meet specific capital needs of SBICs.

Diligent Oversight of Participating SBICs

The vast majority of SBICs have operated in strict conformity with the rules governing the program. Exceptional cases of unjust self-enrichment, fraud or abusive regulatory activities have harmed the industry's image and caused financial losses. COSBI's management must exercise extreme care to assure such abuses do not occur. This will require strict adherence to standards of entry, diligent oversight and efficient enforcement of standards of business conduct. We believe that S.2647 provides COSBI with the authority to pursue vigorously any abuses.

KEY POINTS AND MAJOR CHANGES

As the Committee knows, we have been working on the COSBI proposal for several years. Because it is a complex and dramatic departure from the current structure of the program, with significant implications for the future of our industry, we have exercised great care to assure that we have crafted the most solid piece of legislation possible.

We have spent countless hours consulting with experts; raising and resolving issues; and refining, adjusting and perfecting the bill.

We have drawn on the expertise of budget specialists, accountants, legal counsel and investment bankers with extensive experience in this area. We have consulted with senior officials at other government-sponsored agencies, the SBA and other elements of the Administration. We have worked closely with, and received substantial support from, numerous small business and financial trade associations and groups. Most importantly, throughout this process we have kept all SBICs and MESBICs deeply involved and informed, both members and non-members of our associations.

As a result of these efforts, we concluded that there are five major points in the COSBI proposal which warrant special consideration at this hearing. Because each of these items is essential to the success of COSBI, and because improper treatment of any one of them could unravel the bill, I would like to take the time today to explain our position on each of these points.

1. The Treasury "Backstop"

Every version of the COSBI legislation has provided for some form of a financial "backstop" by the U.S. Treasury. This feature had been patterned after similar backstop provisions provided to other federally-sponsored agencies, such as the Student Loan Marketing Association (SLMA) and the Federal National Mortgage Association (FNMA).

Generally speaking, a Treasury backstop provision says that if the agency in question gets into serious financial difficulty, the Federal Government, via the U.S. Treasury, may, in its discretion, step in to provide support for the agency until it is turned around and restored to a sound financial position. It is not a guaranty by the Federal Government!! It is not a line-of-credit that can be drawn down by the agency!!

The purpose of a backstop is fairly straightforward. To the investment community it has become a key distinguishing factor in the sale of agency securities. Institutional and other sophisticated investors view it as a major comfort factor in their pricing and evaluation of these securities. To them, the backstop, coupled with other features of government sponsorship, creates a perception that the public purposes of the agency are important enough that the Federal Government won't let it fail, and it provides a clear indication that the government will protect the agency's credit position and will step up to the line with financial support if that becomes necessary.

The form of backstop provided to FNMA and SLMA give the Secretary of Treasury unrestricted discretion, within specified dollar limits, to provide financial support to those agencies, if needed. The backstop in our original COSBI bill was designed that way. Even though none of these agency backstops have ever been used, and aren't expected to be, critics of this form of support argue that it is tantamount to a contingent liability of the government, should be considered an "on budget" item, and should be scored for budget purposes, particularly in light of recent budget acts, including Gramm-Rudman-Hollings.

Several commentators have expressed a similar concern with the backstop provision which was in the previous COSBI bill. Others asked if the backstop was essential, or if it could be phased-down or terminated by a sunset provision at some date certain.

We have made an extensive effort to resolve this issue, and I'm convinced we've been successful.

Is the backstop essential? We believe the answer is clearly "yes," it is essential. The investment banking community has advised us that a backstop provision is the single most important item to investment managers who determine whether a security qualifies as an investment grade "agency" security, and the absence of a backstop would severly injure the financial capacity of a new facility like COSBI as it attempted to sell its securities. Without the backstop, the sale of COSBI's securities would be either virtually impossible or the pricing so extreme that COSBI's feasibility would be very questionable.

Can the backstop be phased-out or sunseted? The answer is "no," because a phase-out or sunset feature would be perceived to negate the effect of the backstop. Any type of termination feature would be interpreted by investment managers as a voiding of the implied commitment of the government, making a phased-out or sunseted backstop worthless.

In summary, we've concluded that a backstop is essential to the success of COSBI.

The next step was to restructure the backstop provision in a way that would remove the budget scoring/contingent liability problem. Two significant changes have been made. First, and most important, the backstop authority has now been made subject to the appropriations process, and its discretionary use eliminated. That is, Congress must pass legislation specifically appropriating funds before the Secretary of the Treasury can use the backstop authority. The backstop provision was re-fashioned in this manner to assure Congress that the backstop did not represent a fait accompli and that no financial assistance would be given to COSBI without the direct approval of Congress.

In addition, while a defined ceiling on the amount of the backstop has been retained, the dollar amount has been reduced from $1.0 billion to $500 million.

The House Budget Committee with the concurrence of CBO, has officially determined that the revised version of the backstop in S. 2647 will not be scored as budget authority or outlays. We understand the Senate Budget Committee concurs with this conclusion. At the same time, the investment banking community has advised us that this revised form of backstop authority will continue to be satisfactory for purposes of marketing COSBI's securities. Consequently, we believe the issues related to the backstop have been resolved.

2. **Purchase of the FFB Portfolio**

Each version of the COSBI legislation has had a provision under which the Corporation would purchase the roughly $1.0 billion of outstanding SBIC debentures held by the FFB. Generically, this transaction involves a governmental "sale of assets" which is analagous to the asset sales suggested by the Administration as a way to achieve budget savings.

This particular sale of assets to COSBI, however, has several critical differences.

All of the asset sales proposed by the Administration appear to be randomly selected, with no substantive, program-related purpose.

COSBI's acquisition of the SBIC debentures held by FFB, on the other hand, serves a very important purpose for the SBIC program, small business and COSBI. The Corporation will finance the purchase of the FFB portfolio through the issuance of securities in the capital markets. This transaction will give COSBI an initial asset base and immediate recognition in the capital markets, factors the investment banking community feels are very important to the ultimate success of COSBI.

The Administration has suggested selling SBA and other loan assets as low as 20¢ on the dollar. These proposals have been heavily criticized as penny-wise and pound-foolish "fire sales" because, while they create the appearance of short-term savings, the government actually ends up losing a significant part of the long-term value of the assets being sold.

The COSBI legislation resolves this problem by providing for a true, par value asset sale. Under our proposal, COSBI will buy the SBIC debentures held by FFB, on a guaranteed basis, for 100¢ on the dollar, and COSBI will assume responsibility for servicing those debentures. COSBI will pay full face value for the outstanding debentures. For $1.0 billion in SBIC debentures, COSBI will pay $1.0 billion in cash. Treasury can then invest that $1.0 billion and earn interest on it, or Treasury can use the $1.0 billion to reduce the borrowings on which it pays interest.

In order to insure that appropriate budget "scoring" for this sale of loan assets is achieved, several perfecting changes have been made in this section of the bill. The legislation provides that COSBI will purchase the portfolio during fiscal year 1987. It also specifies that the debentures being purchased are those that mature during fiscal year 1988 and thereafter. These two changes allow CBO to determine the exact budget impact of the sale.

Rather than approaching it piecemeal, I will cover the savings produced by the various elements of the legislation later in my testimony.

There is one additional change in this section of the bill that merits special mention. The old version of the COSBI bill authorized a direct $100 million appropriation to fund the MESBIC Trust. The revised version of the bill now provides that $100 million of the amount COSBI pays for the SBIC debentures shall be paid over to the MESBIC Trust, rather than being paid to Treasury. This offset of a portion of the purchase proceeds avoids the need for Congress to appropriate that amount for the Trust.

3. The MESBIC Trust

S. 2647 retains and strengthens the special-purpose Trust for the MESBIC program. The Trust is designed as a mechanism which can continue to provide the special financial benefits currently available to the MESBIC industry, namely leverage by way of preferred stock and reduced rate debentures.

A series of perfecting changes have been made in the MESBIC Trust section of the bill. The statute now specifically provides for authorization and creation of the Trust; the make-up of the five-member Board of Trustees is spelled out, including the fact that three of the trustees must be from MESBICs; and a specific voting procedure is provided through which MESBICs will nominate the three trustees from the MESBIC industry. In addition, a clause has been added under which the trustees are required to administer the Trust under a "prudent man" standard; the timing for SBA's transfer of the MESBIC assets it holds to the Trust is triggered by COSBI's notice to SBA that it is prepared to conduct business; and the provision for termination of the Trust after fifty years has been made more specific.

We are convinced the Trust will be a very effective vehicle to provide essential support for the MESBIC industry, with no negative implications for the financial position of COSBI.

Mr. Wilkins will provide the Committee with details on how the Trust will operate.

4. The Transition to COSBI

A number of uncertainties existed under the previous version of the legislation regarding the conversion from the present SBA-administered program to COSBI, and the process by which an existing SBIC would make the transition to COSBI's jurisdiction. Perfecting changes have been made in S. 2647 to assure a smooth transition from the present statutory authority to operations under COSBI.

The bill provides that COSBI's authority to finance and regulate SBICs will only go into effect when certain specified events occur. COSBI becomes operational when the Corporation has raised its initial capital, elected a permanent Board of Directors and given notice to SBA that it is ready to conduct business. After those transition actions have been taken, SBA's financial and regulatory authorities no longer apply to SBICs that qualify to do business with COSBI.

As to currently licensed SBICs, only those "in good standing" with SBA can qualify to do business with COSBI. SBICs that are in financial default to SBA or have been placed in a liquidation status for regulatory reasons cannot qualify, and will remain in the normal SBA liquidation process.

An SBIC "in good standing" can qualify to do business with COSBI if it (1) invests in COSBI stock, (2) enters into a contractual agreement to be regulated by COSBI and (3) authorizes the release of its SBA-held records to COSBI. SBICs in good standing are given an ample period of time to qualify with COSBI. They will be able to qualify anytime from the passage of the bill until three months after the date COSBI gives notice to SBA that it is ready to conduct business.

In addition, the provisions relating to SBICs that elect not to qualify with COSBI are clarified and spelled out in more detail. SBA is given a period of six months to promulgate final rules and regulations which spell out the process for winding down the operations of these SBICs. Those SBICs with no financial obligation to SBA have a two-year period to wind down their operations. SBICs that do have outstanding debt with SBA are given a wind-down period which extends two years beyond the date the debt is due or paid.

5. **Oversight of COSBI and the SBIC Industry**

The original COSBI legislation adopted a set of review and oversight activities which have been commonly applied to other government-sponsored enterprises. These included public appointees on the Board; an annual audit of COSBI by an independent CPA; Treasury review of COSBI's financial condition, and access by Treasury to COSBI's books and records; annual financial and program reports to the House and Senate Small Business Committees, the President and the SBA Administrator; and the regulation of SBIC business practices by way of a contract between COSBI and each SBIC. In addition, that version of the bill re-codified several of the restrictions on SBIC activities found in the Small Business Investment Act of 1958, such as the prohibition against conflicts of interest.

In essence, our original approach to the regulatory aspects of the COSBI legislation was one of industry "self-regulation" within defined statutory parameters, and with specifically defined direct oversight by the government.

We felt that approach was justified for several reasons. From a financial perspective, COSBI will be capitalized solely with private funds from the SBIC industry; investors in SBICs will have over $1 billion of private capital at risk under COSBI; the federal guaranty will no longer be attached to any future SBIC leverage; and the singular source of funds for the industry in the future will be the private capital markets, not the government.

From the regulatory perspective, we are convinced that the professional industry leadership elected to COSBI's Board of Directors will do a far better job of regulating the business practices of SBICs than any group of government regulators. When the knowledge and awareness of these professional SBIC managers is coupled with an absolutely compelling self-interest in keeping the industry free from abusive practices, those factors create a tremendous incentive for consistent and diligent oversight and strong enforcement of proper business practices.

However, as a result of our continuing discussions of COSBI with Senate and House Small Business Committee members and staff, officials at SBA and others, it has become very clear that moving from an environment of complete, hands-on government regulation to one of self-regulation would not be acceptable at this time.

Recognizing this reality, several major changes in the legislation have been made which we believe resolve all of the stated concerns about oversight and regulation of the industry.

First, the major SBA regulations which currently govern the operations of SBICs have been codified in very specific terms in the statute. These codified regulations include:

- SBICs can engage only in activities contemplated by the Act.
- The prohibition against detrimental conflicts of interest has been broadened.

- The restrictions against SBICs taking control of small business concerns has been made more explicit.

- SBIC investments must be for a minimum period of five years, and MESBIC investments must have a four year term.

- An SBIC can invest no more than 20% of its capital in any one small business. This investment limit is 30% for MESBICS.

- Financings for the purpose of re-lending, foreign or passive investments, or the acquisition of farm land are specifically prohibited.

- The size standard for a small business in which an SBIC can invest is specifically defined by the statute.

The COSBI contractual relationship which will govern the business practices of SBICs has been retained, and COSBI's authority to enforce compliance with its rules and regulations has been clarified, broadened and strengthened.

In addition, SBA has been brought back into the COSBI scenario. New provisions have been added which give SBA substantial review authority over COSBI to insure that the public purposes of the Act are carried out. SBA is specifically authorized to review COSBI's criteria for the qualification of SBICs and COSBI's rules governing the operations of SBICs. In addition, SBA is authorized to examine COSBI's books and records, to obtain any necessary information from COSBI, and to report the findings of its reviews to Congress. Thus, if problems develop, and SBA is doing its job, SBA will be the first to know about it and will be in a position to immediately alert the House and Senate Small Business Committees so that corrective action can be taken at once. From a Congressional oversight perspective, this would seem to be ideal.

However, because the system can work and remain viable only if it has one regulatory overseer, SBA's review authority stops at the level of COSBI and does not extend to the operations of individual SBICs. Those problems, if any, will be for COSBI to control and correct.

We are convinced that this approach to oversight and regulation of the system is the right one, and that it is a sound, reasonable compromise that will work and produce the results desired by the Committee.

COSBI's IMPACT ON THE FEDERAL BUDGET

Earlier in my testimony I pointed out how COSBI will be of enormous benefit to small business, the venture capital process and the economy as a whole. In addition to those broad economic benefits, the Federal government will also realize a number of immediate and substantial financial gains when the SBIC program is privatized through S. 2647.

Budget Savings

We believe COSBI will generate budgetary savings in excess of $500 million.

We have prepared a chart with a breakdown of the items included in our savings estimate. The chart is attached as an addendum to my testimony. As the chart demonstrates, the major positive items are the cash purchase of the SBIC debentures and the termination of current-law budget authority for the MESBIC program. Together, these items produce a positive budget impact of over $1.0 billion.

Additional Financial Benefits

In addition to the specific budget savings that would be generated by COSBI, I would like to point out to the Committee several additional financial benefits that COSBI will create for the Federal government that don't show up on the budget scorecard:

o You will note that one item on the chart is entitled "Interest realized from investment of cash proceeds," which refers to the Treasury's use of the $825 million in cash it will receive from the sale of the FFB portfolio. We understand that the earnings on these funds technically may not be "scored" for budget purposes as savings in SBA's budget function. However, it seems apparent to us that Treasury can either invest these funds and earn interest, or use these funds to retire outstanding debt and save interest costs. In either case, use of this cash asset will produce real income to the Treasury and real savings of over $200 million which can be directly attributed to S. 2647.

o The SBIC industry currently has private capital of roughly $1 billion. The Small Business Investment Act of 1958 authorizes the SBA to provide leverage to SBICs on a ratio of up to $4 for every $1 of private capital. However, SBICs have only drawn down $1.0 billion. Essentially, this means the government has an outstanding commitment to provide an additional $3 billion in leverage to the SBIC industry. By converting to COSBI, the industry is voluntarily relieving the government of any obligation to provide that $3 billion, and demonstrating our willingness to raise any capital we need in the future on our own.

o Likewise, if the government's commitment to the highly popular MESBIC program were to continue for another 20 years at an average annual level of $50 million, the total direct appropriations involved would be $1 billion. The prospect for these continuing outlays also disappears under COSBI.

o The SBIC program has proven to be one of the most profitable endeavors the government has ever initiated in terms of the new tax revenues the industry has produced over 27 successful years of operation. If our projections of industry growth and expanded flows of capital to small business are correct, COSBI will be an even more productive engine for the generation of new tax revenues.

o COSBI will assume all of the financial, regulatory, administrative and servicing costs and responsibilities for operating the program.

o Most important, by placing over $1 billion of its privately invested capital on the line, the industry will assume the paramount risk that COSBI will work.

When these factors are coupled with the $500 million of budget savings, I'm convinced you will agree that COSBI, as a total package, is clearly a "win-win" proposition for the Federal government.

THE ADMINISTRATION's OPPOSITION TO COSBI

In light of the Administration's current recommendation to terminate the SBIC program and SBA's testimony in the House on the COSBI legislation, we have assumed, for purposes of this testimony, that the Administration will oppose S. 2647.

We are, of course, extremely disappointed that the Administration has opposed COSBI. This opposition is particularly disturbing in light of the Administration's continued pronouncements in favor of (1) "privatizing" government programs, (2) reducing government regulation of private industry and (3) reducing the federal deficit -- three basic concepts which are interwoven into the fabric of COSBI.

The Administration's official position on COSBI is contained SBA's letters to Chairman Weicker, dated December 11, 1984 and January 21, 1986, SBA's testimony in the House on June 24,1986, and OMB Director Miller's letter of July 22, 1986 to members of the House Small Business Committee.

Let me deal first with the letter of December 11, 1984, which provides a detailed statement of SBA's position on COSBI. The January 21, 1986 letter makes reference to the prior letter and adds little of substance. According to our analysis, SBA raised twelve specific points relating to the prior versions of the legislation - four technical points, six substantive issues and two conceptual concerns. I would like to comment on each of these for the record (using the respective headings in the SBA letter).

Technical Points - The four specific technical points raised by SBA have been addressed and corrected in S. 2647.

1. **Approval of the Secretary of the Treasury** - SBA suggested that COSBI's issuance of securities be subject to "approval of," rather than "consultation with," the Secretary of the Treasury.

   S. 2647 makes the issuance of COSBI securities subject to "approval of" the Secretary of the Treasury.

2. **SBA Authorizations and Appropriations** - SBA suggested that the legislation specify that non-qualifying SBICs would not be eligible for refunding, new leverage or available tax advantages.

   S. 2647 addresses this concern by clearly spelling out the procedure for dealing with non-qualifying SBICs, including specific language that they will no longer be eligible for leverage.

3. **Treasury Authorization to Purchase COSBI Obligations** - SBA suggested that the Treasury "backstop" provision be clarified to ensure that it would be used only to protect the credit standing of COSBI and not to refund SBIC obligations to COSBI.

Under S. 2647, not only has the "backstop" been reduced by half, but it is also made clear that the Secretary of Treasury can use this authority only if Congress specifically appropriates funds for this purpose.

4. **Effect on Other SBA Programs** - SBA pointed out that certain repeal provisions in the original bill impaired SBA's ability to investigate participants in other SBA financial programs.

S. 2647 corrects this inadvertent drafting error.

Substantive Issues - SBA also raised six specific points involving more substantive issues. S. 2647 has specifically addressed and resolved three of these concerns.

1. **Regulation of COSBI** - SBA suggested that so long as COSBI had any financial obligation to the Treasury, or the "backstop" was available to assist the Corporation, COSBI should be regulated directly by the Federal Government and be subject to audits by the GAO.

Prior versions of the COSBI legislation proposed that COSBI give Treasury a note for the purchase of the FFB-held SBIC portfolio. Under this form of transaction, the Corporation would have had a continuing financial obligation to the Treasury until the note was paid. Under S. 2647, however, purchase of the FFB portfolio will be accomplished through a cash transaction. No note will be involved, so no financial obligation to Treasury will arise from the transaction.

In addition, no other COSBI obligation to Treasury will occur unless the backstop authority is used, which is highly unlikely. If it were to be used, either Congress, in appropriating funds, or the Secretary of Treasury, in exercising his authority, or both, could subject COSBI to any regulatory or audit conditions they deem appropriate.

Moreover, S. 2647 provides a specific system for oversight of COSBI's operations to ensure that the public purposes of the Act are carried out. SBA is given specific authority to review COSBI's operations; COSBI is subject to audit by the GAO at the request of either the House or Senate Small Business Committees; the accounts of COSBI will be audited annually by an independent certified public accountant; annual reports on COSBI's operations will be submitted to several government agencies; and COSBI is subject to legislative oversight by the Small Business Committees of the Congress.

2. **Assignment of Assets - Assumption of Debts** - The prior version of the COSBI bill provided for a negotiated assignment of the SBIC debentures held by FFB, with a note given to Treasury. SBA suggested that this provision of the statute should specify the terms and conditions of the transaction; that the government hold a lien position on the assets; and that the transaction be at face value.

S. 2647 now clearly spells out that COSBI will pay full face value, in cash, during fiscal year 1987, for SBIC debentures maturing in FY '88 and thereafter. Since this transaction is a sale for cash, and no debt is involved, it would be inappropriate for Treasury to hold a lien position.

3. **COSBI Regulation of SBICs** - SBA suggested that the bill should clearly spell out all regulatory matters to be included in the COSBI contract governing the business practices of SBICs.

S. 2647 has adopted this approach. Virtually all of the significant regulations now in place under SBA have been codified in the bill. In addition, S. 2647 has gone a step further, delineating a more comprehensive framework for regulatory compliance by SBICs under COSBI.

The Issue of Feasibility - SBA also questioned the feasibility of COSBI. SBA took the position that, absent the SBA guarantee on SBIC securities, the asset quality of COSBI would be "speculative at best," compared to investment grade securities of other sponsored agencies such as FNMA and SLMA.

SBA's contention is contrary to all of the expert advice provided to the SBIC industry by virtually every major firm in the investment banking community. These experts are convinced that COSBI will be able to issue investment grade securities at attractive yields, and several investment banking firms have gone on record in suppport of this position.

More important, despite SBA's speculation on this point, the SBIC industry, which has an investment over $1 billion at stake, is willing to risk its future on its conviction that COSBI will work.

Deal Breakers - The three remaining specific points raised by the SBA letters go to the very heart of the COSBI proposal; they could not be accepted by the industry under any circumstances; and the inclusion of any one of them in the bill would unravel the basic concept of COSBI. Each of these points clearly suggests an effort by SBA to protect its "turf." SBA's posture shows a total disregard for the intent of the legislation, and a failure to consider the implications of its position for the ultimate beneficiaries of the bill - small business.

1. **Regulation of SBICs** - SBA takes the position that SBA should continue to regulate the SBIC industry as long as any SBIC or MESBIC enjoys any tax advantage as an SBIC or has any obligation outstanding to, or guaranteed by, SBA.

SBA's position is a misguided attempt to undermine the fundamental concept of privatizing the SBIC industry through COSBI. If SBA continued to directly regulate SBICs, we would be left with a two-track system far more confusing and less efficient than the one currently in place. If the companies in which COSBI invests continued to be subject to the independent regulatory intervention of SBA, COSBI would become a powerless, ineffective financial intermediary, whose financial condition would continually be jeopardized by the whim and fancy of SBA's regulatory actions. Under these circumstances, no sound-thinking SBIC or MESBIC would invest in COSBI's stock or participate in the program; and this type of uncertainty would also destroy COSBI's ability to issue securities in the capital markets.

The regulatory system provided by S. 2647 is a far better answer. It is a reasonable approach that provides a responsible role for SBA, protection of the public purposes of the Act and protection of small business. At the same time, it creates an improved operating environment in which SBICs can effectively serve the financial needs of small business, and it provides an arrangement which will allow COSBI to operate effectively in the capital markets.

2. **Control of COSBI** - SBA also contends that voting control of COSBI should be retained by, and all Directors of COSBI should be appointed by, the Federal Government, as long as COSBI has any obligations outstanding to Treasury, or enjoys the contingent support of Treasury.

This position is simply unacceptable. It reflects a complete lack of understanding of the capital markets, and it would destroy the viability of COSBI.

SBA's position disregards completely the fact that the SBIC investors have over $1 billion of their own private capital at risk. Moreover, it flies in the face of the industry's commitment to invest a minimum of $15 million in COSBI's common stock, to purchase the current SBIC portfolio for $1 billion in cash and to take the inherent risk that COSBI will work.

In addition, governmental control over the private operations of a government-sponsored enterprise would be unprecedented. No similar governmental control is exercised over FNMA or SLMA, for example, nor are we aware that any has ever been proposed.

3. **Participation of SBICs** - SBA objects to the fact that SBICs which elect not to qualify to do business with COSBI will cease being SBICs. SBA indicates that these SBICs should be allowed to continue to operate as SBICs, presumably under SBA's jurisdiction. SBA also asserts that they are aware of many SBICs that do not support COSBI.

SBA's position is rather ironic, since under the Administration's own proposal the total SBIC program would be terminated and all SBICs would lose all their rights. To use SBA's words, "We do not think this is appropriate treatment . . ."

SBA's approach would effectively set up a two-track SBIC system that would undermine the organization and operation of COSBI and defeat the basic purpose of the legislation. Such a system would be ineffective, costly and duplicative; and it would undermine efforts to ensure maximum industry participation in COSBI.

S. 2647 has been modified to provide a clear "soft landing" for those SBICs, if any, that decide not to participate in COSBI. The bill now provides a reasonable period of two years for these companies to wind-down their operations.

We believe, however, that COSBI will achieve very close to 100% participation by the SBIC industry. As you know, we have been working on this proposal for over three years. During that time we have communicated extensively with the industry about COSBI, through national and regional meetings as well as written literature. These communications have gone to the total industry, both members and non-members of our respective associations.

Based on that extensive effort, we are not aware of a single SBIC or MESBIC that has voiced an objection to COSBI, or indicated lack of support for the legislation.

To the contrary, we have specifically surveyed the industry in an effort to obtain positive statements of support for COSBI. And, we think the results are amazing for an industry that has a known reputation for not responding to surveys. We solicited "letters of intent" to support COSBI from some 350 active SBICs. Over 200 (60%) of those companies, representing 70% of the industry's total assets, have advised us that they support COSBI. Not one single SBIC has objected to the legislation or indicated they do not support COSBI.

In addition, the House Small Business Committee solicited every SBIC and MESBIC who are not members of NASBIC or AAMESBIC, and not one of those companies voiced an objection to COSBI.

Obviously, we're very encouraged by this overwhelming support from the industry, for it proves that COSBI will work if given the chance.

Misguided Ideology - Another point raised by SBA is contained in its letter of January 21, 1986, in which the Administration objects to the COSBI legislation on the basis of a rather extreme interpretation of the concept of "privatization."

The Administration indicates that it would support an effort to "truly privatize" or "purely privatize" the SBIC program. It goes on to define its view of pure privatization as the "total disengagement" of any type of Federal support for the industry. From the Administration's perspective, this would include removal of the backstop, the guaranty of any SBIC debentures, the assets transferred to the MESBIC Trust, tax benefits extended to SBICs, seed money for the MESBIC Trust, securities exemptions for COSBI's securities and any other form of government support, no matter how incidental.

OMB Director Miller's letter of July 22, 1986 makes essentially the same point, although his objection is a broadside at all government sponsored enterprises. Under the ideology expressed by Mr. Miller, the Administration would "privatize completely" all federally-sponsored agencies, removing any vestige of federal support for those institutions.

We, of course, regret, and strongly disagree with the extreme, inflexible and totally unworkable position the Administration has taken.

Complete and immediate withdrawal of all forms of government support for this federally created program would destroy the feasibility of every government-sponsored enterprise, including COSBI. SBA has raised questions about COSBI's feasibility, even when the Corporation has the incidents of government support provided by S. 2647; therefore, how can SBA honestly argue that a "purely private" system with no government support whatsoever would work. While COSBI may be a bridge to eventual privatization as the Administration defines it, we cannot get there in one great leap.

Finally, without wanting to appear too sarcastic, it would seem that the Administration has already made the ultimate proposal for privatization of the SBIC industry on their terms. Its proposal was contained in the President's budget for the past two years, and it called for the complete elimination of the program. That proposal makes very clear what the Administration means by privatization through "total disengagement."

CONCLUSION

COSBI was developed over the past three years, with considerable industry input and counsel and advice from experts in the capital markets. We are convinced that COSBI represents a dramatic structural redesign of the SBIC program that will work. It is creative, landmark legislation which will produce enormous rewards for small business and the American economy. We urge your favorable consideration of our COSBI proposal. This concludes my prepared statement, Mr. Chairman. I will be pleased to respond to any questions from the Committee. Thank You.

COSBI BUDGET SAVINGS ESTIMATE

(Three year period FY '87, '88 and '89)
(Dollars in millions)

Estimated Revenue Increases		
Cash purchase of FFB Portfolio	+ 925	
Savings from unused MESBIC budget authority	+ 129	
Savings from reduction in SBA operating costs	+ 6	
		$ 1060 MILLION
Estimated Revenue Decreases		
Expected principal repayments of SBIC debentures	- 163	
Expected interest payments on SBIC debentures	- 233	
Expected principal repayments of MESBIC debentures	- 20	
Expected interest and dividends from MESBIC securities	- 24	
Financing the MESBIC Trust	- 100	
		- 540
Estimated Net Savings		$ 520 MILLION
Interest realized from investment of cash proceeds		+ 214
ESTIMATED TOTAL SAVINGS		$ 734 MILLION

COSBI BUDGET SAVINGS ESTIMATE -- ANNUALIZED

(Dollars in millions)

	1987	1988	1989
Estimated Revenue Increases			
Cash purchase of FFB Portfolio	+ 925	0	0
Savings from unused MESBIC budget authority	+ 41	+ 43	+ 45
Savings from reduction in SBA operating costs	+ 2	+ 2	+ 2
Estimated Revenue Decreases			
Expected principal repayments of SBIC debentures	0	- 85	- 78
Expected interest payments on SBIC debentures	- 78	- 81	- 74
Expected principal payments of MESBIC debentures	- 6	- 7	- 7
Expected interest and dividends from MESBIC securities	- 8	- 8	- 8
Financing the MESBIC Trust	- 100	0	0
Estimated Net Savings	+ 776	- 136	- 120
Interest realized from investment of cash proceeds	+ 66	+ 71	+ 77
ESTIMATED TOTAL SAVINGS	+ 842	- 65	- 43

The Chairman. Thank you very much, Mr. Noojin, for your testimony.

Prior to moving to Mr. Wilkins, I note that Senator Kasten has joined us, and he has a further meeting with a congressional committee, so I would like to, if I might, just interrupt for 1 minute in order that he might make his statement.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator **Kasten**. Mr. Chairman, thank you.

Mr. Wilkins, thank you.

I am in the Commerce Committee downstairs. We are working on product liability for the aviation industry, as well as a couple of other issues that are of great interest to many people in this room, but I want to thank you, Mr. Chairman, for holding this hearing on your bill to amend the Small Business Investment Act of 1958.

The concept of creating a corporation for small business investment, or COSBI, is one that has a great deal of merit. The group that COSBI would oversee, namely, the small business investment companies and the minority enterprise small business investment companies, have a great impact on the economy of our country, and have had a tremendous impact on my State of Wisconsin, and particularly in one part of it.

We in Wisconsin are primarily known for dairy products and beer, but our State has also now become a leader in computer programming, thanks to the emergence of Cray Research in Chippewa Falls. It is just a wonderful company, an outstanding company, and without the help of SBIC's, it is questionable as to whether Cray Research would have gotten off the ground.

Chippewa Falls was once known only for Chippewa and Mason Shoes, as well as Leinenkugel Beer. But it is now recognized as a community on the cutting edge of modern technology. There is no doubt that SBIC's helped in this transformation.

Mr. Chairman, again, I am pleased that you are conducting this hearing. I look forward to working with you on this legislation, thank you very much.

The Chairman. Thank you very much, Senator Kasten.

Now, we have Mr. Herbert Wilkins, president of SYNCOM Capital Corp., and, Mr. Wilkins, it is a delight to have you before the committee. Please proceed.

STATEMENT OF HERBERT P. WILKINS, PRESIDENT, SYNCOM CAPITAL CORP., REPRESENTING THE AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES

Mr. **Wilkins**. Thank you.

Good morning, Mr. Chairman, and members of the Senate Small Business Committee.

I am Herbert Wilkins, president of SYNCOM Capital Corp., and I represent the American Association of Minority Enterprise Small Business Investment Companies.

I have been working on the development of the COSBI legislation for several years now, and it occurred to me this morning, after listening to the prior comments, that perhaps I ought to add something to what I had prepared as a presentation for this group.

I heard this morning that the administration does not seek to continue the funding of the program. It occurred to me when I heard that, that in the news recently I have heard many people—farmers, businessmen—all across the country, talking about the need for America to be able to compete with other people to have a level playing field.

For the minority community in the United States, to some extent the MESBIC industry has provided a level playing field.

To give an example: We recently became involved in the development of a cable TV system in the city of Newark, NJ. There were 10 MESBIC's involved in the financing of that company. In addition, there was one insurance company whose social responsibility lending group provided long-term debt at 15 percent, with a 10-percent gross participation in the gross value of that system if it were ever sold. That's social responsibility lending in America. That's a level playing field.

TCI, on the other hand, can go to Drexel, Burnham to raise hundreds of millions of dollars—TCI is the largest cable company in America—and obtain low-cost money and give very little equity.

The MESBICs in this deal made the difference, because we provided equity; we made sure that the entrepreneurs in that company had 51 percent of the equity, and that the investors only took 49 percent. That made the difference.

On the other hand, for the residents of Newark, they would never have gotten a cable system if it had not been for the MESBIC's, because no one else was prepared to build there.

Teleprompter had the franchise for 10 years and never hung a wire. No other bidder bid for that cable TV franchise.

I just wanted to make that point: that MESBIC's make the difference for minority entrepreneurs. If you look at the list of the 100 largest—black-owned companies—roughly half of those companies were financed, or have current financing from MESBIC's, and about 75 percent of those companies were financed at one time or another by MESBIC's. We do make the difference.

There is a need for COSBI and the MESBIC industry.

Why does the MESBIC industry need COSBI? Why can't we continue on in the current relationship that we have now with the SBA?

We need COSBI because we need the consistency, the stability that an identified source of capital like COSBI would provide.

In the past 4 years, we have been threatened at least 3 times with the loss of funding because of the way the appropriation for the industry is generated in the congressional process.

That creates a concern; it creates an instability in the industry, and it jeopardizes our ability to provide the minority community that level playing field that they are looking for.

We believe that the MESBIC trust that has been proposed as a part of COSBI would provide the kind of credit worthiness that would allow the MESBIC industry to continue in the private sector and receive capital.

I think that many people have questioned the credibility of the MESBIC's as long-term creditors. I would submit to you that the loss rate of the MESBIC industry is almost as good as most of the Nation's banks today. Our historical loss rate is running around 3 percent. That is not true for many of these major—major—financial institutions which will not lend in the minority community.

We believe, as a result of all of this, that there is an absolute necessity for the creation of COSBI, for the development of the MESBIC trust, and for the support that is necessary for the minority communities in this country to continue to grow.

We take exception to the strong objections proposed by the administration for COSBI. We take exception to the position taken by the Inspector General. We do believe that there is built into the present structure sufficient controls, and, as was indicated by Mr. Noojin, we are prepared to sit down and work with the administration and the staff to ensure that everybody feels comfortable with the structure of the legislation and its controls.

I would like to stop there.

[The prepared statement of Mr. Wilkins follows:]

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TESTIMONY

BY

HERBERT P. WILKINS
LEGISLATIVE CHAIRMAN

AMERICAN ASSOCIATION OF MESBICs

BEFORE THE

SENATE SMALL BUSINESS COMMITTEE

AUGUST 7, 1986

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JAMES S. YU
Intercontinental Capital
Funding Corp.
New York, New York

Good morning Mr. Chairman and members of the Senate Small Business Committee. I am Herbert P. Wilkins, President of SYNCOM Capital Corporation in Washington, D. C., and Legislative Chairman of the American Association of Minority Enterprise Small Business Investment Companies (AAMESBIC).

It is my pleasure to be here today to testify in support of S2647, a bill to create the Corporation for Small Business Investment (COSBI). As one who has worked several years now in developing the concept of the Corporation, I am pleased to offer my assistance in furthering the legislation's progress through both chambers of Congress.

The MESBIC industry has come a long way in its short history. The idea for our industry was first developed in the late sixties. Using the Small Business Investment Company industry as a model, the Nixon administration approached several large U. S. private institutions for investment capital for minority small businesses. In turn, the government provided matching funds for minority investment. Thus, corporate America and the U. S. government joined together in a partnership to promote the participation of minorities in the U. S. economic system. In 1971, the first year for which MESBIC investment figures are available, the average MESBIC investment was less than $13,000, and the industry's total investments amounted to only $2.2 million. By 1985, MESBICs had reached an annual investment figure of $107.7 million, with the majority of our investments at over $100,000.

OVER THE YEARS, MESBIC EXECUTIVES HAVE BECOME MORE ADEPT AS INVESTORS IN DISCERNING THOSE MINORITY ENTREPRENEURS AND SMALL BUSINESSES WHICH HAVE THE BEST OPPORTUNITY TO SUCCEED. OUR INVESTMENTS TODAY ARE MUCH LARGER THAN THEY WERE IN THE EARLY DAYS, AND THE ENTREPRENEURS MORE SOPHISTICATED. MANY OF OUR INVESTMENTS ARE IN CONSORTIUM DEALS, DRAWING ADDITIONAL PRIVATE DOLLARS TO THE MINORITY SMALL BUSINESS COMMUNITY. IN ADDITION, THESE SUCCESSFUL ENTREPRENEURS ARE PROVIDING IMPORTANT EMPLOYMENT AND MANAGEMENT TRAINING OPPORTUNITIES TO OTHER MINORITIES.

THE MESBIC PROGRAM IS A LEADER IN MINORITY SMALL BUSINESS DEVELOPMENT. CONTRARY TO ADMINISTRATION CLAIMS, THERE ARE NOT OTHER SIMILAR SOURCES OF VENTURE CAPITAL AVAILABLE TO THE COMMUNITY WE SERVE. OUR INDUSTRY OFFERS A CADRE OF SKILLED, EXPERIENCED, AND ETHNICALLY DIVERSE INVESTORS WHO UNDERSTAND THE SPECIAL NEEDS OF MINORITY ENTREPRENEURS AND ARE WELL-EQUIPPED TO SERVE THOSE NEEDS. THE PRIVATE/PUBLIC PARTNERSHIP NATURE OF OUR INDUSTRY INSURES THAT OUR INVESTORS' TIME AND MONEY ARE WISELY SPENT. BY PLACING OUR PRIVATE CAPITAL AT RISK FIRST, OUR PROGRAM WAS DEVELOPED IN A WAY TO INSURE THAT OUR INVESTMENTS WOULD BE MADE IN THOSE COMPANIES EXHIBITING THE GREATEST POTENTIAL FOR SUCCESS.

NO OTHER SOURCE OF MINORITY VENTURE CAPITAL CAN CLAIM THE BREADTH OF EXPERIENCE POSSESSED BY MESBICS. AND OUR EXPERIENCE PRODUCES RESULTS. BETWEEN 1978 AND 1985, WE INVESTED OVER $462 MILLION IN 5,422 MINORITY OWNED SMALL BUSINESSES. THESE SAME COMPANIES PRODUCED OVER $4.5 BILLION IN REVENUES AND CREATED OVER

82,000 JOBS. LAST YEAR ALONE, OUR INVESTMENTS RESULTED IN THE CREATION OF OVER $150 MILLION IN TAX REVENUE.

SO IF THE INDUSTRY IS DOING SO WELL AND ACCOMPLISHING SO MUCH, WHY DO WE NEED TO MOVE INTO THE CORPORATION FOR SMALL BUSINESS INVESTMENT? THERE IS ONE SIMPLE ANSWER TO THAT QUESTION - STABILITY. IT IS ABSOLUTELY ESSENTIAL THAT, AS LONG TERM CAPITAL INVESTORS, WE HAVE A STABLE FUNDING SOURCE AND STABLE RULES BY WHICH WE MAKE OUR INVESTMENTS.

ANNUAL SBA APPROPRIATIONS ARE NO LONGER A RELIABLE FUNDING SOURCE. IN THE PAST FIVE YEARS, WE HAVE BEEN TEMPORARILY ELIMINATED FROM THE BUDGET AS AN "OVERSIGHT" BY THE SENATE BUDGET COMMITTEE, WE HAVE BEEN FROZEN AT A CONSTANT LEVEL, OUR FUNDS HAVE BEEN DECREASED, AND WE HAVE BEEN THREATENED TWICE WITH ELIMINATION AS PART OF THE SBA'S CREDIT PROGRAMS.

THE RESULTING UNCERTAINTY IN TERMS OF FUTURE FUNDING LEAVES OUR INVESTORS IN A VERY DIFFICULT SITUATION. SEVERAL HUNDRED MILLION DOLLARS OF PRIVATE CAPITAL FROM CORPORATIONS, INDIVIDUALS, COMMUNITIES, AND OTHER SOURCES HAVE BEEN INVESTED IN THEIR COMPANIES. IF THEY WANT TO INSURE THE AVAILABILITY OF FUNDS FOR FUTURE INVESTMENTS, THEY ARE COMPELLED TO ATTEMPT TO RAISE ADDITIONAL PRIVATE CAPITAL. ON THE OTHER HAND, THOSE PRIVATE CAPITAL SOURCES ARE LESS WILLING TO PROVIDE MORE FUNDS IF THE MESBIC CAN'T ASSURE THEM THAT THEIR FUNDS WILL BE MATCHED WITH GOVERNMENT LEVERAGE IN THE FUTURE. GIVEN THIS SITUATION, MESBIC EXECUTIVES CAN MAKE ONE OF TWO CHOICES: THEY CAN CONTINUE TO SEEK OUT NEW COMPANIES IN WHICH TO INVEST AND HOPE THAT ADDITIONAL FUNDS WILL BE AVAILABLE IN THE FUTURE, OR THEY CAN HOLD ON

TO THEIR MONEY TO FINANCE THEIR EXISTING PORTFOLIO'S FUTURE NEEDS. OUR INVESTMENT RECORD SHOWS WE'VE CHOSEN TO KEEP UP OUR INVESTMENTS AND OUR HOPES. BUT WE CAN NOT CONTINUE TO RELY ON GOOD FORTUNE TO SEE US THROUGH.

AS IF FUNDING INSTABILITY WERE NOT ENOUGH, WE ARE ALSO FACED WITH AN EXTREMELY ERRATIC ADMINISTRATION OF THE REGULATIONS. IN THE PAST FIVE YEARS, WE HAVE UNDERGONE A COMPLETE OVERHAUL OF THE INDUSTRY'S REGULATIONS, A MORATORIUM ON THE ISSUANCE OF NEW LICENSES, AND WE ARE NOW DEALING WITH AN ACTING SBA ADMINISTRATOR WHO WANTS TO COMPLETELY ELIMINATE OUR INDUSTRY.

WE CAN NOT CONTINUE TO OPERATE IN THIS ATMOSPHERE OF FINANCIAL AND ADMINISTRATIVE UNCERTAINTY. COSBI WOULD REMOVE MESBICS FROM THIS ENVIRONMENT AND PROVIDE THEM WITH A MORE RELIABLE FUNDING SOURCE AND REGULATORS WHO UNDERSTAND THE OPERATIONAL REQUIREMENTS IN MAKING LONG TERM INVESTMENTS.

THE CORPORATION FOR SMALL BUSINESS INVESTMENT REPRESENTS THE CULMINATION OF EXTENSIVE WORK ON THE PART OF THE MESBIC AND SBIC INDUSTRIES, PUBLIC POLICY MAKERS, AND WALL STREET ANALYSTS. ALL OF THE PARTIES WORKED TOGETHER TO DEVELOP A BILL TO ESTABLISH COSBI. THEY ENVISIONED THE CORPORATION AS THE MOST EFFECTIVE APPROACH TO COMBINED GOVERNMENT EFFORTS TO FOSTER SMALL BUSINESS DEVELOPMENT AND ITS RESULTING JOB CREATION AND INNOVATION WITH THE INCREASED STABILITY AND ACCESS TO PRIVATE CAPITAL AN INSTITUTION SUCH AS COSBI WOULD PROVIDE.

COSBI'S OPERATIONAL STRUCTURE

THERE ARE FOUR MAJOR AREAS IN WHICH THE SBA PRESENTLY REGULATES THE MESBIC AND SBIC INDUSTRIES: MANAGEMENT, FUNDING, LICENSING, AND MONITORING. COSBI WILL REPLACE SBA REGULATION OF THESE AREAS IN WHAT WE BELIEVE WILL BE AN EFFICIENT AND EFFECTIVE MANNER.

MANAGEMENT

UNDER THE COSBI PROPOSAL, IMMEDIATELY AFTER IT IS ESTABLISHED, COSBI WILL BE MANAGED BY AN INTERIM BOARD OF DIRECTORS APPOINTED BY THE PRESIDENT. THE BOARD WILL CONSIST OF TWO REPRESENTATIVES OF THE SBIC INDUSTRY, TWO SMALL BUSINESS REPRESENTATIVES, AND THE SBA ADMINISTRATOR. THIS BOARD WILL BE RESPONSIBLE FOR ARRANGING COSBI'S INITIAL $20 MILLION STOCK OFFERING, WHICH WILL BE RAISED FROM THE MESBIC AND SBIC LICENSEES.

ONCE THE $20 MILLION STOCK OFFERING IS COMPLETED, A PERMANENT BOARD WILL REPLACE THE INTERIM BOARD. THE PERMANENT BOARD WILL CONSIST OF 15 MEMBERS. TEN OF THESE MEMBERS WILL BE ELECTED BY STOCKHOLDERS THROUGH CUMULATIVE VOTING RIGHTS. THE OTHER FIVE MEMBERS WILL BE APPOINTED BY THE PRESIDENT, WITH AT LEAST ONE COMING FROM THE MESBIC INDUSTRY.

THE TEN ELECTED BOARD MEMBERS ARE EXPECTED TO COME FROM AMONG THE LEADERSHIP OF THE MESBIC AND SBIC INDUSTRIES. AS SUCH, THEY WOULD BRING TO THEIR POSITIONS YEARS OF EXPERIENCE IN THE

VENTURE CAPITAL INDUSTRY. THIS EXPERIENCE WILL HELP THEM IN THEIR ROLES AS POLICY MAKERS FOR COSBI. THE FIVE POLITICALLY-APPOINTED BOARD MEMBERS WILL ENSURE THAT THE BOARD CONTINUES TO SET AS HIGH PRIORITIES THE PUBLIC POLICY GOALS FOR WHICH THE CORPORATION IS BEING ESTABLISHED. IN A SENSE, THE MAKE-UP OF THE BOARD WILL SERVE TO CREATE A SYSTEM OF CHECKS AND BALANCES WHICH WILL RESULT IN THE PURSUANCE OF THESE GOALS IN THE MOST EFFICIENT MANNER POSSIBLE.

IN ADDITION, COSBI WILL HAVE THE RESPONSIBILITY OF SUBMITTING AN ANNUAL REPORT AND AUDIT TO THE TREASURY, THE PRESIDENT, THE SBA, AND THE HOUSE AND SENATE SMALL BUSINESS COMMITTEES.

FUNDING

AS A SOURCE OF FUNDS, COSBI WOULD POOL SECURITIES ISSUED BY MESBICs AND SBICs AND ISSUE ITS OWN SECURITIES ON THE MARKET. ITS GOVERNMENT SPONSORSHIP WOULD ALLOW COSBI TO BORROW AT FAVORABLE RATES, SIMILAR TO OTHER FEDERALLY SPONSORED AGENCIES SUCH AS THE FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC) AND THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE). UNDER COSBI, MESBICs AND SBICs ADMITTEDLY WOULD HAVE TO PAY HIGHER RATES FOR THEIR FUNDS. WE BELIEVE, HOWEVER, THAT THERE ARE MANY OTHER FACTORS THAT WOULD COMPENSATE FOR THIS INCREASED COST OF MONEY. CHIEF AMONG THESE FACTORS IS THE INCREASED FUNDING STABILITY WE WOULD ACHIEVE THROUGH COSBI. WE BELIEVE WE WILL HAVE MORE CONTROL OVER OUR ACCESS TO FUNDS WHEN IT IS BASED ON OUR LONG TERM SUCCESS AS INVESTORS, RATHER THAN ON THE ANNUAL

APPROPRIATIONS PROCESS.

THE MESBIC AND SBIC INDUSTRIES WOULD BE RESPONSIBLE FOR PROVIDING THE INITIAL CAPITALIZATION OF THE CORPORATION. ALL OPERATING COMPANIES WOULD INVEST 2% OF THEIR PRIVATE CAPITAL IN THE CORPORATION'S COMMON STOCK --PRODUCING A TOTAL INITIAL CAPITAL POOL OF APPROXIMATELY $20 MILLION. OUR INDUSTRIES ARE WILLING TO MAKE THIS INVESTMENT BECAUSE WE BELIEVE THE FUNDING STABILITY AND OTHER BENEFITS WE WILL RECEIVE FROM THE CORPORATION WILL BE WORTH IT IN THE LONG RUN.

AS I WILL DISCUSS IN MORE DETAIL LATER, A TRUST WILL BE ESTABLISHED WITHIN COSBI TO ADDRESS THE SPECIAL INVESTMENT NEEDS OF MESBICs. IN ESSENCE, FOR A PERIOD OF 50 YEARS THE TRUST WILL BE USED AS A "SELF-SUSTAINING" ASSET BASE TO PROVIDE THE FINANCIAL INCENTIVES FOR THE MESBIC PROGRAM. CONVERSELY, IF THESE ASSETS DO NOT PRODUCE SUFFICIENT INCOME, THE RATE DIFFERENTIAL ON DEBENTURES AND THE OPTION OF ISSUING PREFERRED STOCK WOULD NO LONGER BE AVAILABLE TO MESBICs. THE CONTINUED EXISTENCE OF THE TRUST THEREFORE RELIES ON OUR SUCCESS AS SMALL BUSINESS INVESTORS.

AT THE END OF THE FIFTY YEAR PERIOD, THE LIQUIDATING TRUST WILL TERMINATE AND ANY OUTSTANDING PREFERRED STOCK AND DIVIDENDS, ALONG WITH THE REMAINING CORPUS OF THE TRUST, WILL BE TRANSFERRED TO THE U.S. TREASURY. AFTER THAT DATE, THE FINANCIAL INCENTIVES FOR MESBICs WILL TERMINATE. IN THE 50 YEAR INTERIM, COSBI WILL ESTABLISH SEPARATE ACCOUNTING FOR THE TRUST OPERATIONS TO THE SECRETARY OF THE TREASURY.

LICENSING

THERE ARE SEVERAL REQUIREMENTS FOR OBTAINING A LICENSE TO OPERATE AS A SMALL BUSINESS INVESTMENT COMPANY. CHIEF AMONG THESE ARE THE CAPITALIZATION LEVEL (AT LEAST $1 MILLION), THE REQUIREMENT OF A STATE CHARTER, AND SPECIFIC STANDARDS ON MANAGEMENT EXPERTISE. THIS RESTRICTION OF ENTRY INTO THE INDUSTRY WAS DESIGNED TO PROTECT THE GOVERNMENT DOLLARS THAT GO INTO THE PROGRAM.

COSBI IS DESIGNED TO PROVIDE SIMILAR PROTECTION OF INVESTMENTS IN THE CORPORATION. COSBI WOULD REPLACE SBA'S LICENSING SYSTEM WITH CONTRACTUAL AGREEMENTS BETWEEN THE CORPORATION AND SBICs. NEW MESBICs AND SBICs WOULD HAVE TO MEET CRITERIA SIMILAR TO THOSE PRESENTLY USED BY THE SBA. COSBI WILL HAVE THE AUTHORITY TO SUSPEND OR TERMINATE THE CONTRACTS OF SBICs FOUND TO BE IN BREACH OF THOSE CONTRACTS. THE CONTRACTUAL ARRANGEMENT IS ALSO EXPECTED TO BE MORE EXPEDIENT THAN THE PRESENT LICENSING PROCESS. THUS, COSBI LICENSING IS EXPECTED TO PROVIDE THE SAME ADVANTAGES OF THE PRESENT SYSTEM, WITH A SHORTER TIME REQUIREMENT.

MONITORING AND AUDITING

THE SBA MONITORS THE MESBIC INDUSTRY THROUGH ITS REPORT FILING REQUIREMENTS. MESBICs MUST SUBMIT YEAR-END AUDITED FINANCIAL STATEMENTS, ANNUAL PORTFOLIO INFORMATION FORMS, AND PORTFOLIO FINANCING FORMS AFTER EACH INVESTMENT TRANSACTION. ADDITIONALLY, THE SBA CONDUCTS ANNUAL AUDITS OF EACH MESBIC'S

INVESTMENTS AND ACTIVITIES. THE PURPOSE OF THESE MONITORING ACTIVITIES IS TO ENSURE THAT ALL LICENSEES ARE OPERATING IN COOPERATION WITH THE SMALL BUSINESS INVESTMENT ACT AND THE RULES AND REGULATIONS PERTAINING TO THE ACT.

UNDER COSBI, LICENSEES WILL BE REQUIRED BY THEIR CONTRACTUAL AGREEMENTS WITH THE CORPORATION TO SUBMIT TO AUDITS BY COSBI TO ASSURE COMPLIANCE WITH ITS REQUIREMENTS. IN ADDITION, THE SBA REGULATION THAT AN INDEPENDENT EXTERNAL AUDIT BE CONDUCTED WILL NOT CHANGE.

I WOULD LIKE TO STRESS HERE THE DIFFERENCE BETWEEN THE REGULATORY ROLES OF COSBI AND THE SBA. THE SBA IS SPECIFICALLY AUTHORIZED TO REVIEW COSBI'S CRITERIA FOR THE QUALIFICATION OF SBICS AND RULES GOVERNING THE OPERATIONS OF SBICS. SBA'S AUTHORITY DOES NOT EXTEND, HOWEVER, TO COSBI'S INTERNAL OPERATIONS OR TO THE OPERATIONS OF INDIVIDUAL SBICS. THAT WILL BE THE RESPONSIBILITY OF THE CORPORATION. IN CARRYING OUT ITS GENERAL OVERSIGHT DUTIES, THE SBA IS AUTHORIZED TO EXAMINE COSBI'S BOOKS AND RECORDS, TO OBTAIN ANY NECESSARY REPORTS FROM COSBI, AND TO REPORT THE FINDINGS OF ITS REVIEWS TO CONGRESS.

IT IS IMPORTANT TO NOTE HERE THAT THE HOUSE BILL HAS BEEN AMENDED TO INCLUDE AN EXCEPTION TO THIS RULE. IN THOSE CASES WHERE A SMALL BUSINESS INVESTMENT COMPANY HAS OUTSTANDING SECURITIES HELD OR GUARANTEED BY THE ADMINISTRATION, THE ADMINISTRATION WILL HAVE ACCESS TO ANY FINANCIAL AUDIT OR CERTIFIED FINANCIAL REPORT FILED WITH THE CORPORATION. THIS AMENDMENT WAS ADDED TO THE BILL IN RECOGNITION OF THE SBA'S NEED TO EVALUATE

THE FINANCIAL RISK TO THE FEDERAL GOVERNMENT ON SBIC OBLIGATIONS HELD BY, OR GUARANTEED BY, THE SBA. IT IS ALSO IMPORTANT TO NOTE THAT SBA HAS ACCESS ONLY TO THE FINANCIAL REPORTS FILED WITH THE CORPORATION BY THESE COMPANIES. COSBI WILL MAINTAIN ALL REGULATORY OVERSIGHT OF THE INDIVIDUAL COMPANIES.

THE CORPORATION WILL ESTABLISH OPERATING STANDARDS BY WHICH ALL MESBICS AND SBICS MUST ABIDE. THESE STANDARDS, AS I MENTIONED BEFORE, WILL BE BASED ON PRESENT SBA REGULATIONS AND GENERALLY ACCEPTED OPERATING STANDARDS FOR SIMILAR INSTITUTIONS. THESE STANDARDS WILL BE SET FORTH IN CONTRACTUAL AGREEMENTS BETWEEN COSBI AND THE INDIVIDUAL INVESTMENT COMPANIES. IT IS BELIEVED THIS SYSTEM WILL PROVIDE MORE REGULATORY STABILITY BECAUSE ANY CHANGES WOULD REQUIRE APPROVAL BY THE BOARD OF COSBI, THE MAJORITY OF WHOM WILL HAVE BEEN VOTED IN BY THE INDUSTRY AS COSBI SHAREHOLDERS, AND WHO ARE EXPECTED TO BE COGNIZANT OF THE SPECIAL NEEDS OF LONG TERM INVESTORS. THUS, THE COSBI BOARD OF DIRECTORS WILL SERVE THE OVERSIGHT FUNCTION FOR THE "BUSINESS PURPOSES" OF THE CORPORATION.

THE REGULATORY STRUCTURE OF COSBI ALSO PROVIDES FOR OVERSIGHT OF THE "PUBLIC PURPOSES" OF THE CORPORATION. CONGRESS, THE PRESIDENT, SBA AND TREASURY WOULD EACH BE GIVEN SPECIFIC OVERSIGHT RESPONSIBILITIES IN THIS AREA. THE PRESIDENT WOULD PRACTICE HIS OVERSIGHT RESPONSIBILITIES THROUGH HIS APPOINTMENT OF FIVE OF THE FIFTEEN COSBI BOARD MEMBERS. THE SBA, AS MENTIONED EARLIER, WOULD MONITOR THE GENERAL RULES AND REGULATIONS AND WOULD REQUIRE REPORTS ON COSBI'S ACTIVITIES. THE

TREASURY WOULD HAVE THE RESPONSIBILITY OF APPROVING ALL COSBI OBLIGATIONS ISSUED, AND CONGRESS WOULD HAVE ONGOING LEGISLATIVE OVERSIGHT OF THE CORPORATION.

MESBIC FUNDING

AT THIS POINT, I WOULD LIKE TO GO INTO A LITTLE MORE DETAIL REGARDING MESBIC FUNDING. UNLIKE REGULAR SBICS, MESBICS SPECIALIZE IN INVESTING IN SMALL BUSINESSES OWNED BY SOCIALLY OR ECONOMICALLY DISADVANTAGED ENTREPRENEURS. IN RECOGNITION OF THE ADDITIONAL RISK THAT COMES WITH INVESTING IN A RESTRICTED GROUP OF SMALL BUSINESSES, MESBICS HAVE RECEIVED INCENTIVES BEYOND THOSE OFFERED TO REGULAR SBICS.

MESBICS MAY OBTAIN MATCHING GOVERNMENT FUNDS IN ONE OF TWO WAYS. THE FIRST SOURCE OF LEVERAGE IS THROUGH SBA PREFERRED STOCK PURCHASES FROM THE MESBICS. THE SECOND SOURCE IS SBA DEBENTURES ISSUED TO MESBICS WITH A 3% INTEREST RATE SUBSIDY ON THE FIRST FIVE YEARS OF A TEN YEAR DEBENTURE. FOR EXAMPLE, ON A 12% 10 YEAR DEBENTURE, A MESBIC WOULD PAY 9% THE FIRST FIVE YEARS AND 12% THE SECOND FIVE YEARS.

THESE PROVISIONS HAVE ALLOWED MESBICS TO CONTINUE TO SERVE THE IMPORTANT PUBLIC POLICY GOALS OF PROMOTING MINORITY ENTREPRENEURSHIP, MANAGEMENT TRAINING, AND EMPLOYMENT. AND BY COMBINING PUBLIC WITH PRIVATE FUNDS THESE PUBLIC POLICY GOALS ARE ACHIEVED AT A MINIMAL COST TO THE GOVERNMENT WITH MAXIMUM EFFICIENCY AND EFFECTIVENESS. IN FACT, A RECENT STUDY SHOWED THAT FOR EVERY DOLLAR THE GOVERNMENT INVESTS IN THE MESBIC

PROGRAM, IT RECEIVES OVER TWELVE DOLLARS IN TAX REVENUE AND OTHER BENEFITS.

COSBI WOULD CONTINUE TO SERVE THESE GOALS BY SETTING UP A TRUST WITHIN THE CORPORATION TO CONTINUE TO ENCOURAGE INVESTMENTS IN THE MINORITY SMALL BUSINESS COMMUNITY. THE TRUST WOULD BE ESTABLISHED BY TRANSFERRING THE EXISTING MESBIC PORTFOLIO FROM THE SBA TO COSBI FOR A PERIOD OF 50 YEARS. THE TRUST WOULD ALSO RECEIVE $100 MILLION FROM THE PROCEEDS OF THE SALE OF THE FFB ASSETS TO COSBI. THE CASH GENERATED FROM THE TRUST WOULD BE USED TO CONTINUE TO PROVIDE AN INTEREST RATE SUBSIDY ON MESBIC DEBENTURES AND TO PURCHASE PREFERRED STOCK IN MESBICS. MESBICS, LIKE OTHER SBICS, WOULD GO TO THE COSBI WINDOW FOR DEBENTURES, AND WOULD HAVE TO MEET THE CREDIT CRITERIA SET FORTH BY THE CORPORATION. THE DIFFERENCE WOULD BE THAT, FOR DEBENTURES ISSUED TO MESBICS, THE TRUST WOULD PROVIDE AN INTEREST RATE SUBSIDY FOR THE FIRST FIVE YEARS.

THE TRUST FUNDS WOULD ALSO BE USED FOR OTHER PURPOSES. SPECIFICALLY, THE FUNDS WOULD BE USED TO COVER THE OPERATING COSTS OF ADMINISTERING THE TRUST AND TO COVER ANY LOSSES REALIZED ON MESBIC PREFERRED SECURITIES OR DEBENTURES. THIS LATTER USE WILL INSURE THAT COSBI WILL RECEIVE A COMPETITIVE MARKET RATE ON ITS SECURITIES.

ADMINISTRATION OF THE TRUST WILL BE PERFORMED BY FIVE TRUSTEES. THE SELECTION PROCESS FOR THE TRUSTEES HAS BEEN CAREFULLY DEVELOPED TO INSURE THAT THE INTERESTS OF MESBICS, THE CORPORATION, AND THE PUBLIC ARE ALL WELL REPRESENTED. THREE OF

THE TRUSTEES WILL BE NOMINATED BY MESBICs AND APPOINTED BY COSBI'S BOARD OF DIRECTORS. FURTHER, AT LEAST THREE OF THE TRUSTEES WILL, AT ALL TIMES, BE PERSONS FROM MESBICs. THIS REQUIREMENT GUARANTEES THAT THE MAJORITY OF THE TRUSTEES WILL HAVE EXPERIENCE IN THE INDUSTRY AND WILL ADMINISTER THE TRUST WITH THE BEST INTERESTS OF MESBICs IN MIND.

THE NOMINATION OF TRUSTEES BY MESBICs WILL BE BY CUMMULATIVE VOTE, BASED ON THE NUMBER OF SHARES OF VOTING COMMON STOCK OF THE CORPORATION HELD BY EACH MESBIC. EACH OF THE TRUSTEES NOMINATED BY THE MESBICs WILL BE APPOINTED AS TRUSTEES BY THE CORPORATION'S BOARD OF DIRECTORS UNLESS, FOR GOOD CAUSE SHOWN, THE BOARD REFUSES TO APPROVE A NOMINEE, IN WHICH EVENT A NEW NOMINEE WILL BE NOMINATED BY THE MESBIC INDUSTRY. THE APPOINTED NOMINEES WILL SERVE THREE YEAR TERMS, WITH EACH SERVING NO MORE THAN TWO CONSECUTIVE TERMS.

IN ADDITION TO THE MESBIC INDUSTRY NOMINEES, THERE WILL BE TWO OTHER TRUSTEES. ONE OF THE TRUSTEES WILL BE APPOINTED BY THE PRESIDENT, TO SERVE AT THE PRESIDENT'S PLEASURE. THIS PERSON WILL REPRESENT THE PUBLIC INTEREST IN THE ADMINISTRATION OF THE TRUST. THE FINAL TRUSTEE WILL BE EX-OFFICIO, THE CHAIRMAN OF THE BOARD OF DIRECTORS OF THE CORPORATION, OR HIS DESIGNEE. THUS, THE INTERESTS OF THE CORPORATION AS A WHOLE ALSO WILL BE REPRESENTED.

THE TRUSTEES APPOINTED BY THE CORPORATION WILL HAVE CUSTODY AND CONTROL OF THE TRUST TO ADMINISTER, SELL, INVEST AND REINVEST THE TRUST ESTATE. THE TRUST WILL ESTABLISH SEPARATE ACCOUNTING for all preferred securities, debentures, loss reserves, and other funds acquired and the application of those funds. The trustees will make an annual accounting of the trust's operations to the Secretary of the Treasury.

At AAMESBIC's request, I developed a computer model of the operations of the trust that demonstrates the trust's ability to continue to operate for the full 50 year period. The 50 year computer model is attached to my testimony for your review.

The first page of the model gives a breakdown of the MESBIC portfolio currently held by the SBA. This portfolio would be transferred to COSBI to be held in trust for a period of fifty years. The income generated by the portfolio during the interim would be used to finance new MESBIC leverage. To estimate the income generated by the portfolio each year, we looked at the debentures maturing each year, plus interest earned on non-maturing debentures, added in expected dividends on preferred stock, and subtracted out for expected losses and remaining debenture subsidies to be paid. The various assumptions for the calculations are attached to the model and are based on figures obtained from the Small Business Administration's Investment Division. The annual expected income generation from the portfolio is given in the final column.

The second page of the model begins the analysis of the income and expenses of the trust from 1986 through 2037. At the top are listed the sources of income for the trust. These include the initial balance of the trust, funds generated by the

EXISTING PORTFOLIO, AND INTEREST EARNED ON MONIES HELD. LISTED NEXT ARE THE TRUST DISBURSEMENTS, WHICH INCLUDE PREFERRED STOCK PURCHASES FROM MESBICs, SUBSIDIES PAID ON DEBENTURES, THE ADMINISTRATIVE FEE PAID TO THE CORPORATION BY THE TRUST, AND FUNDED LOSS RESERVES.

AS WE WERE DEVELOPING THE CONCEPT OF THE MESBIC TRUST WITHIN COSBI, WE TRIED TO COME UP WITH THE LEAST COSTLY WAY OF CONTINUING TO FINANCE THE MESBIC PROGRAM WITHOUT HAVING TO COME BACK TO THE SMALL BUSINESS COMMITTEES SOME TIME IN THE FUTURE TO REQUEST ADDITIONAL APPROPRIATIONS. WE WANTED TO DEVELOP A TRULY SELF-SUSTAINING TRUST. WE HAVE ACHIEVED THIS IN SEVERAL WAYS. FIRST, THE COSBI LEGISLATION REQUIRES THAT $100 MILLION OF THE BUDGET SAVINGS AS A RESULT OF THE FFB SALE OF ASSETS BE TRANSFERRED TO THE TRUST. SECOND, THE LEGISLATION ALSO REQUIRES THAT THE EXISTING MESBIC PORTFOLIO BE TRANSFERRED TO THE TRUST FOR A PERIOD OF 50 YEARS. THESE TWO PROVISIONS ALONE WOULD SUSTAIN THE INDUSTRY FOR SOME TIME, BUT NOT FOR 50 YEARS AND NOT AT A HEALTHY GROWTH RATE. WE THEREFORE ADDED AN ADDITIONAL ASSUMPTION TO OUR TRUST. WE WOULD OFFER MESBICs WITH OUTSTANDING PREFERRED THE OPPORTUNITY TO BUY IT BACK AT A DISCOUNT.

BASED ON DISCUSSIONS WITH MESBIC EXECUTIVES, WE BELIEVE APPROXIMATELY 70% OF THE OUTSTANDING PREFERRED WOULD BE PURCHASED. FOR THE PURPOSES OF THE MODEL, WE HAVE ASSUMED 50% WOULD BUY BACK THEIR PREFERRED THE FIRST YEAR, 10% THE SECOND YEAR, AND 10% THE THIRD. THESE BUY-BACKS PROVIDE SUFFICIENT FUNDS TO MAKE THE TRUST COMPLETELY SELF-SUSTAINING AT A HEALTHY RATE OF GROWTH

FOR A PERIOD OF FIFTY YEARS. IN FACT, WHEN THE MODEL IS RUN OUT OVER A FIFTY YEAR PERIOD, BY 2037 THE TRUST HAS A BALANCE OF $1.7 BILLION, WITH $444.7 MILLION IN CASH, $176.9 MILLION IN PREFERRED STOCK RECEIVABLE, $1.083 BILLION IN FUNDED LOSS RESERVES, AND $16.3 MILLION IN PREFERRED DIVIDENDS RECEIVABLE. THE TRUST ALSO WOULD CARRY A LIABILITY OF $855,236 IN DEBENTURE SUBSIDIES PAYABLE, WHICH COULD BE PAID FROM THE CASH BALANCE. THUS, AT THE END OF THE 50 YEAR PERIOD, THE U. S. TREASURY WOULD RECEIVE A TRUST CORPUS OF SEVERAL HUNDRED MILLION DOLLARS.

THE TRUST REPRESENTS A RELATIVELY SMALL GOVERNMENT OUTLAY TO ACHIEVE SIGNIFICANT RESULTS TOWARDS CLEARLY STATED PUBLIC POLICY GOALS. THE ONE-TIME $100 MILLION TRANSFER, WHICH REPRESENTS APPROXIMATELY TWO AND A HALF YEARS' APPROPRIATIONS TO MESBICs AT OUR CURRENT LEVEL, IS EXPECTED TO SUSTAIN THE SPECIAL INCENTIVES FOR MINORITY INVESTMENTS AND JOB CREATION FOR A FULL FIFTY YEARS. IN ADDITION, THE TRUST'S COVERAGE OF ANY LOSSES COSBI MIGHT INCUR ON MESBIC DEBENTURES WOULD MAKE COSBI A MORE ATTRACTIVE MARKET OPPORTUNITY. ONLY MESBIC DEBENTURES CAN OFFER A GUARANTEE AGAINST LOSSES THROUGH THE TRUST. THE MESBIC PORTION OF COSBI'S PORTFOLIO IS THUS VIRTUALLY RISK FREE IN THE EYES OF OUTSIDE INVESTORS IN THE CORPORATION'S SECURITIES. THIS FACT, IN TURN, SHOULD LEAD TO INCREASED ACCESS TO CAPITAL MARKETS FOR THE SBIC INDUSTRY AS A WHOLE. THUS, THE ONE-TIME TRANSFER OF $100 MILLION WOULD LEAD TO INCREASED SMALL BUSINESS INVESTMENT, JOB CREATION, AND INNOVATION IN BOTH THE MINORITY AND MAJORITY COMMUNITIES. AND IT WOULD DO SO AT A TIME WHEN OTHER FACTORS, SUCH AS THE PROPOSED ELIMINATION OF CAPITAL GAINS TAX RATES, MIGHT BE DRYING UP OTHER

SOURCES OF VENTURE CAPITAL.

CONCLUSION

IN SUMMARY, COSBI REGULATION AND FUNDING OF THE MESBIC INDUSTRY IS EXPECTED TO OFFER MANY OF THE BENEFITS OF GOVERNMENT REGULATION AND FUNDING IN ADDITION TO MANY NEW BENEFITS. THE COMBINED SHAREHOLDER-ELECTED/PRESIDENTIALLY APPOINTED BOARD WILL OFFER VENTURE CAPITAL EXPERIENCE AND PUBLIC INTEREST REPRESENTATION. THE STABILITY OF FUNDS IS EXPECTED TO BE IMPROVED BY REMOVING THE INDUSTRY FROM ITS RELIANCE ON THE ANNUAL APPROPRIATIONS PROCESS. A LICENSING PROCESS AND MONITORING AND AUDITING FUNCTIONS HAVE BEEN DEVELOPED FOR THE CORPORATION THAT WILL CONTINUE TO SERVE THE PUBLIC POLICY GOALS ACHEIVED BY THE SBA REGULATION OF THE INDUSTRY, WHILE FITTING IN TO THE PRIVATE SECTOR FUNCTIONS OF THE CORPORATION.

AS A RESULT OF THESE CHANGES, THE SMALL BUSINESS INVESTMENT COMPANY INDUSTRY, AND THE SMALL BUSINESSES IN WHICH IT INVESTS, WILL BE BETTER SERVED. MESBICS WILL OPERATE IN A MORE STABLE REGULATORY ENVIRONMENT WITH GREATER ACCESS TO CAPITAL MARKETS THROUGH A FINANCIAL INTERMEDIARY DESIGNED TO MEET THE UNIQUE NEEDS OF SBICS. COSBI WILL PROVIDE ACCESS FOR SMALL BUSINESSES TO THE MAJOR CAPITAL MARKETS, INCREASING THE FLOW OF CAPITAL TO SMALL BUSINESSES BY MANY HUNDREDS OF MILLIONS OF DOLLARS PER YEAR.

I THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE FOR THIS OPPORTUNITY TO TESTIFY BEFORE YOUR COMMITTEE AND WOULD BE HAPPY TO ANSWER ANY OF YOUR QUESTIONS.

MESBIC Trust Analysis

Intro

The data used to generate the attached model of the MESBIC trust were obtained from Jack Werner, Director of the Office of Investment of the Small Business Administration. These data include: 1) The schedule and report on Section 301(d) SBIC debentures as of December 31, 1985; 2) The balance outstanding on MESBIC preferred stock as of December 31, 1985; 3) The outstanding leverage to operating Section 301(d) SBICs as of December 31, 1985; 4) The Section 301(d) SBIC preferred stock dividends calendar; 5) The total outstanding Section 301(d) SBIC leverage as of December 31, 1985; and 6) The Section 301(d) SBICs paying dividends as of December 31, 1985. It should be noted that the interest rates on the debenture schedule were understated by approximately 3%. Our model compensated for this discrepancy by taking a weighted average of the interest rates on the portfolio of approximately 12%.

Analysis of Existing SBA Debenture Portfolio

The amount of the existing debenture portfolio maturing each year is given in Column A of the attached table. The reserve for losses on non-operating companies given in Column C was derived by multiplying Column A by 18.58%. This figure represents the ratio of debentures held by non-operating companies to total outstanding debentures. We have thus assumed that approximately 18.58% of the debentures maturing each year will not be paid that year.

Column D represents the interest earned each year on the outstanding MESBIC debentures. As mentioned earlier in the introduction, we are working with a weighted average interest rate of 12%. Thus, in year 1, we would earn interest on the total outstanding portfolio of approximately $100,267,973 which would amount to $12,032,157. ($100,267,973 x 12 = $12,032,157). The 12% interest earned in later years would be applied to a declining balance as the debentures held reached maturity. Column E represents the portion of interest earned that is held by non-operating companies and is derived simply by multiplying the amount each year in Column D by .1858. In other words, Column E represents the amount of interest earned on debentures each year which is estimated uncollectible.

Column F, the remaining debenture subsidy, is taken directly from SBA records. Dividends paid currently, given in Column G, are a constant amount based on the 1985 level. This amount was used as a reasonable estimate because there was no way to accurately reflect the true amount.

Net interest and dividends paid, given in Column H, represents interest earnings (Column D - Column E) less the remaining debenture subsidy (Column F) plus dividend payments (Column G). Finally, to determine the total annual cash flow generated for the trust, the maturing debentures, minus the loss reserve, (Column A- Column C) are added to the net interest and dividends paid (Column H). Thus, the total annual cash flow generated by the existing MESBIC portfolio that would be available to the trust is given in Column I.

MESBIC Trust Analysis

The trust has three sources of funds for investment; 1) The initial amount transferred by Congress; 2) Cash generated by the MESBIC portfolio including buybacks on the existing preferred and calls on the newly issued preferred; and 3) Interest earned on available funds assuming a constant interest rate of 8%. Disbursements from the fund take the form of preferred stock purchases, 3% subsidies on MESBIC debentures, fees paid for administration of the trust, and funded loss reserves, which are an estimated 9% of debentures issued and which are not drawn down in this analysis. In addition, the debentures subsidy assumes an average six month subsidy for new debentures issued each year.

Model

The model examines the operations of the trust over a 50 year period given the following assumptions:

1) The trust receives a $100 million transfer from the FFB sale of assets in year 1.
2) MESBICs are given the option of buying back their existing preferred at 40 cents on the dollar. 50% of outstanding preferred is assumed to be bought back in year 1, 10% in year 2, and 10% in year 3. The income from these sales is reflected under initial balance for these years.
3) Newly issued preferred stock is 3% cumulative, with a 10 year call provision. Preferred stock purchases by the trust are assumed to decrease 4.25% per year, with 82% of the calls recoverable. As the stock is called, it is assumed that the stock is rolled over into a debenture with a 3% subsidy paid by the trust for the first five years.
4) Debentures are assumed to carry a 3% subsidy on the interest rate for the first five years. The amount of debentures issued increases 7.7% per year.
5) Debenture subsidies end after year 45 to prevent the trust from having a debenture subsidies payable liability at the end of the 50 year period.

Given the above assumptions, the model shows that the trust would continue to operate profitably for the entire 50 year period. At the end of 50 years, the trust would have a balance of over $1.7 billion, with $444.7 million in cash, $176.9 million in preferred stock receivable, $1.083 billion in funded loss reserves, and $16.3 million in preferred dividends receivable. The trust also would carry a liability of $855,236 in debenture subsidies payable, which could be paid from the cash balance.

CHART 1

MESBIC TRUST ANALYSIS

AAMESBIC Analysis of Existing SBA Debenture Portfolio

DEBENTURE MATURITY DATE	AMOUNT MATURING EACH YEAR A	% REPAID EACH YEAR B	RESERVE FOR LOSSES NON-OPERATING C	INTEREST EARNED D	LESS INTEREST FROM NON-OPERATING E	REMAINING DEBENTURE SUBSIDY F	DIVIDENDS PAID CURRENTLY G	NET INTEREST AND DIVIDEND PAID H	INCOME AND REPAID DEBENTURES I
				12.00%	18.58%	3.00%			
12/31/85	5,921,474	5.91%	1,100,210	12,032,157	2,235,575	1,737,799	861,867	8,920,650	13,741,914
12/31/86	6,398,607	6.38%	1,188,861	11,321,580	2,103,550	1,476,372	517,120	8,258,779	13,468,525
12/31/87	6,271,828	6.26%	1,165,306	10,553,747	1,960,886	990,444	448,171	8,050,588	13,157,110
12/31/88	6,844,612	6.83%	1,271,729	9,801,128	1,821,050	438,912	379,221	7,920,387	13,493,270
12/31/89	4,905,068	4.89%	911,362	8,979,774	1,668,442	61,445	379,221	7,629,108	11,622,815
12/31/90	11,999,758	11.97%	2,229,555	8,391,166	1,559,079	4,937	379,221	7,206,372	16,976,575
12/31/91	8,714,233	8.69%	1,619,104	6,951,195	1,291,532	3,918	379,221	6,034,966	13,130,095
12/31/92	16,197,590	16.15%	3,009,512	5,905,487	1,097,240	2,888	379,221	5,184,581	18,372,659
12/31/93	18,384,390	18.34%	3,415,820	3,961,776	736,098	1,052	379,221	3,603,848	18,572,418
12/31/94	12,582,240	12.55%	2,337,780	1,755,680	326,200		379,221	1,808,671	12,053,131
12/31/95	1,883,602	1.88%	349,973	245,781	45,666		379,221	579,336	2,112,965
12/31/96	33,968	0.03%	6,311	19,749	3,669		379,221	395,301	422,957
12/31/97	34,333	0.03%	6,379	15,672	2,912		379,221	391,982	419,936
12/31/98	61,207	0.06%	11,372	11,552	2,146		379,221	388,627	438,462
12/31/99	35,063	0.03%	6,515	4,208	782		379,221	382,647	411,196
TOTALS	100,267,973	100.00%	18,629,789	79,950,621	14,854,825	4,717,767	6,377,816	66,755,844	148,394,028

CHART 6

Funds Beginning	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Initial balance	134,710,454	142,540,866	151,023,726	153,719,151	154,683,937	161,206,508	164,694,675	174,311,601	185,266,593	190,613,812
Portfolio funds	13,468,520	13,157,106	13,493,268	11,622,812	16,976,572	13,130,093	18,372,656	18,572,415	12,053,129	2,112,963
Interest earnings	11,019,801	11,831,613	12,728,396	13,047,848	13,536,430	14,142,001	14,888,926	15,956,628	16,867,902	17,173,854
	159,198,775	167,529,585	177,245,390	178,389,811	185,196,939	188,478,602	197,956,257	208,840,644	214,187,624	209,900,629
Disbursements:										
Preferred stock	20,000,000	19,150,000	18,336,125	17,556,840	16,810,674	16,096,220	15,412,131	14,757,115	14,129,938	13,529,416
Debentures subsidy	300,000	923,100	1,594,179	2,316,930	3,095,334	3,333,675	3,590,368	3,866,826	4,164,572	4,485,244
Administrative fee	1,500,000	1,436,250	1,508,063	1,583,466	1,662,639	1,745,771	1,833,060	1,924,713	2,020,949	2,121,996
Funded loss reserves	1,800,000	1,938,600	2,087,872	2,248,638	2,421,784	2,608,261	2,809,097	3,025,397	3,258,353	3,509,246
	23,600,000	23,447,950	23,526,239	23,705,874	23,990,431	23,783,927	23,644,656	23,574,051	23,573,812	23,645,902
Remaining balance	135,598,775	144,081,635	153,719,151	154,683,937	161,206,508	164,694,675	174,311,601	185,266,593	190,613,812	186,254,727
COSBI Debentures issued	20,000,000	21,540,000	23,198,580	24,984,871	26,908,706	28,980,676	31,212,188	33,615,526	36,203,922	18,991,624
Cumulative debs. 107.7%	20,000,000	41,540,000	64,738,580	89,723,451	116,632,157	145,612,833	176,825,021	210,440,547	246,644,469	285,636,093

Debenture reserve 9%
Recoverable preferred 82%

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Pref. outstanding	173,552,268	104,131,360	90,247,178	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	20,000,000	39,150,000	57,486,125	75,042,965	91,853,639	107,949,859	123,361,990	138,119,105	152,249,043	165,778,459
95.75%	193,552,268	143,281,360	147,733,303	151,405,961	168,216,635	184,312,855	199,724,986	214,482,101	228,612,039	242,141,455
1st yr. buy-back@50%	34,710,454									
2nd yr. buy-back@10%	6,942,091									
3rd yr. buy-back@10%	6,942,091									
Total proceeds	48,594,636									

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Assets										
Cash	135,598,775	144,081,635	153,719,151	154,683,937	161,206,508	164,694,675	174,311,601	185,266,593	190,613,812	186,254,727
Debentures rec	94,346,499	87,947,892	81,676,064	74,831,452	69,926,384	57,926,626	49,212,393	33,014,803	14,630,413	2,048,173
Preferred rec.	193,552,268	143,281,360	147,733,303	151,405,961	168,216,635	184,312,855	199,724,986	214,482,101	228,612,039	242,141,455
Funded loan rec	1,800,000	3,718,600	5,826,472	8,075,110	10,496,894	13,105,155	15,914,252	18,939,649	22,198,002	25,707,248
Pref. div. rec.	20,796,219	17,289,472	15,424,410	15,534,590	16,038,910	16,521,797	16,984,160	17,426,874	17,850,772	18,256,655
Total	446,093,761	396,338,959	404,379,400	404,531,050	425,885,331	436,561,108	456,147,392	469,130,020	473,905,038	474,408,258
Liabilities										
Deb. subs payable	5,679,968	6,997,424	8,444,120	9,813,476	10,749,511	11,759,019	12,847,591	14,022,042	15,288,058	16,651,558
Trust balance	440,413,793	389,341,535	395,935,280	394,717,574	415,135,820	424,802,089	443,299,801	455,107,978	458,616,980	457,756,700
Total liab&bal	446,093,761	396,338,959	404,379,400	404,531,050	425,885,331	436,561,108	456,147,392	469,130,020	473,905,038	474,408,258

Funds Beginning	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Initial balance	186,254,727	179,908,665	195,334,064	211,174,568	227,397,739	243,612,494	260,219,877	277,222,621	294,619,760	312,406,100
Portfolio funds	422,956	21,739,936	20,852,362	19,957,506	18,715,592	17,920,179	17,158,570	16,429,331	15,731,084	15,062,514
Interest earnings	17,023,559	17,701,857	19,308,372	20,972,964	22,680,337	24,433,016	26,249,743	28,133,049	30,085,331	32,108,820
	203,701,242	219,350,458	235,494,798	252,105,038	268,793,668	285,965,689	303,628,190	321,785,001	340,436,175	359,577,434
Disbursements:										
Preferred stock	12,954,416	12,403,853	11,876,689	11,371,930	10,888,623	10,425,857	9,982,758	9,558,491	9,152,255	8,763,284
Debentures subsidy	4,830,607	5,202,564	5,603,162	6,034,605	6,499,270	6,999,714	7,538,691	8,119,171	8,744,347	9,417,662
Administrative fee	2,228,096	2,339,501	2,456,476	2,579,300	2,708,265	2,843,678	2,985,862	3,135,155	3,291,913	3,456,509
Funded loss reserves	3,779,458	4,070,476	4,383,903	4,721,464	5,085,016	5,476,563	5,898,258	6,352,424	6,841,560	7,368,360
	23,792,577	24,016,394	24,320,230	24,707,299	25,181,174	25,745,812	26,405,569	27,165,241	28,030,075	29,005,815
Remaining balance	179,908,665	195,334,064	211,174,568	227,397,739	243,612,494	260,219,877	277,222,621	294,619,760	312,406,100	330,571,619
COSBI debentures issued	41,993,979	45,227,515	48,710,034	52,460,707	56,500,181	60,850,695	65,536,199	70,582,486	76,017,337	81,870,672
Cumulative debs.	327,630,072	372,857,587	421,567,621	474,028,328	530,528,509	591,379,204	656,915,403	727,497,889	803,515,226	885,385,898
Pref. outstanding	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	178,732,875	174,736,728	170,910,417	167,246,724	163,738,738	160,379,842	157,163,700	154,084,244	151,135,665	148,312,400
	255,095,871	251,099,724	247,273,413	243,609,720	240,101,734	236,742,838	233,526,696	230,447,240	227,498,661	224,675,396
Calls on pref.	0	16,400,000	15,703,000	15,035,623	14,396,609	13,784,753	13,198,900	12,637,947	12,100,834	11,586,549
Accrued dividends	0	4,920,000	4,710,900	4,510,687	4,318,983	4,135,426	3,959,670	3,791,384	3,630,250	3,475,965
	0	21,320,000	20,413,900	19,546,310	18,715,592	17,920,179	17,158,570	16,429,331	15,731,084	15,062,514

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Assets										
Cash	179,908,665	195,334,064	211,174,568	227,397,739	243,612,494	260,219,877	277,222,621	294,619,760	312,406,100	330,571,619
Debentures rec.	164,571	130,603	96,270	35,063	0	0	0	0	0	0
Preferred rec.	255,095,871	251,099,724	247,273,413	243,609,720	240,101,734	236,742,838	233,526,696	230,447,240	227,498,661	224,675,396
Funded loss res.	29,486,706	33,557,182	37,941,085	42,662,549	47,747,565	53,224,128	59,122,386	65,474,810	72,316,370	79,684,730
Pref. div. rec.	18,645,287	18,525,403	18,410,613	18,300,702	18,195,463	18,094,696	17,998,212	17,905,828	17,817,371	17,732,673
Total	483,301,100	498,646,976	514,895,949	532,005,773	549,657,256	568,281,539	587,869,915	608,447,638	630,038,502	652,664,418
Liabilities										
Deb. subs payable	18,120,048	19,701,611	21,404,954	23,239,455	25,215,212	27,343,102	29,634,841	32,103,043	34,761,297	37,624,236
Trust balance	465,181,052	478,945,365	493,490,995	508,766,318	524,442,044	540,938,437	558,235,074	576,344,595	595,277,205	615,040,182
Total liab&Bal	483,301,100	498,646,976	514,895,949	532,005,773	549,657,256	568,281,539	587,869,915	608,447,638	630,038,502	652,664,418

Funds Beginning	2006	2007	2008	2009	2010	2011	2012	2013	2014
Initial balance	330,571,619	349,100,796	367,971,867	387,155,987	406,616,301	426,306,901	446,171,669	466,142,997	486,140,356
Portfolio funds	14,422,357	13,809,407	13,222,507	12,660,551	12,122,478	11,607,272	11,113,964	10,641,621	10,189,352
Interest earnings	34,205,544	36,377,292	38,625,562	40,951,512	43,355,900	45,839,016	48,400,608	51,039,800	53,754,992
	379,199,520	399,287,495	419,819,936	440,768,050	462,094,679	483,753,189	505,686,241	527,824,418	550,084,700
Disbursements:									
Preferred stock	8,390,844	8,034,233	7,692,778	7,165,835	7,052,787	6,753,044	6,466,040	6,191,233	5,928,106
Debentures subsidy	10,142,822	10,923,819	11,764,953	12,670,854	13,646,510	14,697,291	15,828,983	17,047,814	18,360,496
Administrative fee	3,629,334	3,810,801	4,001,341	4,201,408	4,411,478	4,632,052	4,863,655	5,106,838	5,362,180
Funded loss reserve	7,935,724	8,546,775	9,204,877	9,913,652	10,677,003	11,499,133	12,384,566	13,338,177	14,365,217
	30,098,724	31,315,628	32,663,949	34,151,749	35,787,778	37,581,520	39,543,244	41,684,062	44,015,999
Remaining balance	349,100,796	367,971,867	387,155,987	406,616,301	426,306,901	446,171,669	466,142,997	486,140,356	506,068,701
COSBI debentures issued	88,174,714	94,964,167	102,276,408	110,151,691	118,633,371	127,768,141	137,606,288	148,201,972	159,613,524
Cumulative debs.	973,560,612	1,068,524,779	1,170,801,187	1,280,952,878	1,399,586,249	1,527,354,390	1,664,960,678	1,813,162,650	1,972,776,174
Pref. outstanding	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	145,609,123	143,020,735	140,542,354	138,169,304	135,897,108	133,721,481	131,638,318	129,643,689	127,733,832
	221,972,119	219,383,731	216,905,350	214,532,300	212,260,104	210,084,477	208,001,314	206,006,685	204,096,828
Calls on pref.	11,094,121	10,622,621	10,171,159	9,738,885	9,324,983	8,928,671	8,549,203	8,185,862	7,837,963
Accrued dividends	3,328,236	3,186,786	3,051,348	2,921,666	2,797,495	2,678,601	2,564,761	2,455,759	2,351,389
	14,422,357	13,809,407	13,222,507	12,660,551	12,122,478	11,607,272	11,113,964	10,641,621	10,189,352

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Assets									
Cash	349,100,796	367,971,867	387,155,987	406,616,301	426,306,901	446,171,669	466,142,997	486,140,356	506,068,701
Preferred rec.	221,972,119	219,383,731	216,905,350	214,532,300	212,260,104	210,084,477	208,001,314	206,006,685	204,096,828
Funded loss res.	87,620,454	96,167,229	105,372,106	115,285,758	125,962,761	137,461,894	149,846,460	163,184,617	177,549,854
Pref. div. rec.	17,651,574	17,573,923	17,499,571	17,428,380	17,360,214	17,294,945	17,232,450	17,172,611	17,115,316
Total	676,344,943	701,096,750	726,933,014	753,862,739	781,889,980	811,012,985	841,223,221	872,504,289	904,830,699
Liabilities									
Deb. subs payable	40,707,621	44,028,427	47,604,935	51,456,835	55,605,331	60,073,261	64,885,221	70,067,703	75,649,236
Trust balance	635,637,322	657,068,323	679,328,079	702,405,904	726,284,649	750,939,724	776,338,000	802,436,586	829,181,463
Total liab&bal.	676,344,943	701,096,750	726,933,014	753,862,739	781,889,980	811,012,985	841,223,221	872,504,289	904,830,699

Funds Beginning	2015	2016	2017	2018	2019	2020	2021	2022	2023
Initial balance	506,068,701	525,816,720	545,254,878	564,233,253	582,579,141	600,094,410	616,552,562	631,695,494	645,229,924
Portfolio funds	9,756,304	9,341,661	8,944,640	8,564,492	8,200,501	7,851,981	7,518,271	7,198,745	6,892,799
Interest earnings	56,543,758	59,402,728	62,327,454	65,312,261	68,350,088	71,432,298	74,548,478	77,686,213	80,830,832
	572,368,761	594,561,109	616,526,972	638,110,006	659,129,730	679,378,689	698,619,311	716,580,452	732,953,555
Disbursements:									
Preferred stock	5,676,161	5,434,924	5,203,940	4,982,773	4,771,005	4,568,237	4,374,087	4,188,188	4,010,190
Debentures subsidy	19,774,254	21,296,872	22,936,731	24,702,859	26,604,979	28,653,563	30,859,887	33,236,098	35,795,278
Administrative fee	5,630,289	5,911,803	6,207,393	6,517,763	6,843,651	7,185,834	7,545,126	7,922,382	8,318,501
Funded loss reserve	15,471,339	16,662,632	17,945,655	19,327,470	20,815,685	22,418,493	24,144,717	26,003,860	28,006,157
	46,552,043	49,306,231	52,293,719	55,530,865	59,035,320	62,826,127	66,923,817	71,350,528	76,130,126
Remaining balance	525,816,720	545,254,878	564,233,253	582,579,141	600,094,410	616,552,562	631,695,494	645,229,924	656,823,429
COSBI debentures issued	171,903,765	185,140,355	199,396,162	214,749,666	231,285,390	249,094,365	268,274,631	288,931,778	311,179,525
Cumulative debs.	2,144,679,939	2,329,820,294	2,529,216,456	2,743,966,122	2,975,251,512	3,224,345,877	3,492,620,508	3,781,552,286	4,092,731,811
Pref. outstanding	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	125,905,144	124,154,175	122,477,621	120,872,325	119,335,252	117,863,504	116,454,306	115,104,998	113,813,035
	202,268,140	200,517,171	198,840,619	197,235,321	195,698,248	194,226,500	192,817,302	191,467,994	190,176,031
Calls on pref.	7,504,849	7,185,893	6,880,492	6,588,071	6,308,078	6,039,985	5,783,285	5,537,496	5,302,153
Accrued dividends	2,251,455	2,155,768	2,064,148	1,976,421	1,892,423	1,811,996	1,734,986	1,661,249	1,590,646
	9,756,304	9,341,661	8,944,640	8,564,492	8,200,501	7,851,981	7,518,271	7,198,745	6,892,799

	2015	2016	2017	2018	2019	2020	2021	2022	2023
Assets									
Cash	525,816,720	545,254,878	564,233,253	582,579,141	600,094,410	616,552,562	631,695,494	645,229,924	656,823,429
Preferred rec.	202,268,140	200,517,171	198,840,619	197,235,321	195,698,248	194,226,500	192,817,302	191,467,994	190,176,031
Funded loan res.	193,021,193	209,683,825	227,629,480	246,956,950	267,772,635	290,191,128	314,335,845	340,339,705	368,345,862
Pref. div. rec.	17,060,455	17,007,926	16,957,629	16,909,471	16,863,358	16,819,206	16,776,930	16,736,451	16,697,692
Total	938,166,508	972,463,800	1,007,660,981	1,043,680,883	1,080,428,651	1,117,789,396	1,155,625,571	1,193,774,074	1,232,043,014
Liabilities									
Deb. subs payable	81,660,547	88,134,728	95,107,421	102,617,012	110,704,842	119,415,434	128,796,742	138,900,411	149,782,062
Trust balance	856,505,961	884,329,072	912,553,560	941,063,871	969,723,809	998,373,962	1,026,828,829	1,054,873,663	1,082,260,952
Total liab & bal.	938,166,508	972,463,800	1,007,660,981	1,043,680,883	1,080,428,651	1,117,789,396	1,155,625,571	1,193,774,074	1,232,043,014

Funds Beginning	2024	2025	2026	2027	2028	2029	2030	2031	2032
Initial balance	656,823,429	666,100,085	672,635,653	675,952,267	675,512,580	670,713,316	660,878,161	645,249,934	622,981,979
Portfolio funds	6,599,854	6,319,361	6,050,788	5,793,629	5,547,400	5,311,636	5,085,891	4,869,740	4,662,776
Interest earnings	83,965,130	87,069,056	90,119,373	93,089,275	95,947,966	98,660,192	101,185,730	103,478,814	105,487,505
	747,388,413	759,488,502	768,805,814	774,815,171	777,007,946	774,685,144	767,149,782	753,598,488	733,132,260
Disbursements:									
Preferred stock	3,839,757	3,676,567	3,520,313	3,370,700	3,227,445	3,090,279	2,958,942	2,833,187	2,712,777
Debentures subsidy	38,551,514	41,519,981	44,717,019	48,160,230	51,868,568	55,862,447	60,163,856	64,796,473	69,785,801
Administrative fee	8,734,426	9,171,147	9,629,704	10,111,189	10,616,748	11,147,585	11,704,964	12,290,212	12,904,723
Funded loss reserve	30,162,631	32,485,154	34,986,511	37,680,472	40,581,869	43,706,672	47,072,086	50,696,637	54,600,278
	81,288,328	86,852,849	92,853,547	99,322,591	106,294,630	113,806,983	121,899,848	130,616,509	140,003,579
Remaining balance	666,100,085	672,635,653	675,952,267	675,512,580	670,713,316	660,878,161	645,249,934	622,981,979	593,128,681
COSBL debentures issued	335,140,348	360,946,155	388,739,009	418,671,913	450,909,650	485,629,693	523,023,179	563,295,964	606,669,753
Cumulative debs.	4,427,872,159	4,788,818,314	5,177,557,323	5,596,229,236	6,047,138,886	6,532,768,579	7,055,791,758	7,619,087,722	8,225,757,475
Pref. outstanding	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	112,575,981	111,391,501	110,257,362	109,171,424	108,131,638	107,136,043	106,182,761	105,269,994	104,396,020
	188,938,977	187,754,497	186,620,358	185,534,420	184,494,634	183,499,039	182,545,757	181,632,990	180,759,016
Calls on pref.	5,076,811	4,861,047	4,654,452	4,456,638	4,267,231	4,085,874	3,912,224	3,745,954	3,586,751
Accrued dividends,	1,523,043	1,458,314	1,396,336	1,336,991	1,280,169	1,225,762	1,173,667	1,123,786	1,076,025
	6,599,854	6,319,361	6,050,788	5,793,629	5,547,400	5,311,636	5,085,891	4,869,740	4,662,776

	2024	2025	2026	2027	2028	2029	2030	2031	2032
Assets									
Cash	666,100,085	672,635,653	675,952,267	675,512,580	670,713,316	660,878,161	645,249,934	622,981,979	593,128,681
Preferred rec.	188,938,977	187,754,497	186,620,358	185,534,420	184,494,634	183,499,039	182,545,757	181,632,990	180,759,016
Funded loan res.	398,508,493	430,993,647	465,980,158	503,660,630	544,242,499	587,949,171	635,021,257	685,717,894	740,318,172
Pref. div. rec.	16,660,580	16,625,046	16,591,022	16,558,443	16,527,250	16,497,382	16,468,784	16,441,401	16,415,181
Total	1,270,208,135	1,308,008,843	1,345,143,805	1,381,266,073	1,415,977,699	1,448,823,753	1,479,285,732	1,506,774,264	1,530,621,050
Liabilities									
Deb. subs. payable	161,501,600	174,123,542	187,717,374	202,357,931	218,125,811	235,107,818	253,397,439	273,095,361	294,310,023
Trust balance	1,108,706,535	1,133,885,301	1,157,426,431	1,178,908,142	1,197,851,888	1,213,715,935	1,225,888,293	1,233,678,903	1,236,311,027
Total liab & bal	1,270,208,135	1,308,008,843	1,345,143,805	1,381,266,073	1,415,977,699	1,448,823,753	1,479,285,732	1,506,774,264	1,530,621,050

Funds Beginning	2033	2034	2035	2036	2037
Initial balance	593,128,681	538,996,758	494,940,671	462,975,955	445,379,249
Portfolio funds	4,464,608	4,274,863	4,093,181	3,919,221	3,752,654
Interest earnings	106,515,468	107,307,211	109,371,838	112,912,758	118,158,044
	704,108,757	650,578,832	608,405,690	579,807,934	567,289,947
Disbursements:					
Preferred stock	2,597,484	2,487,091	2,181,390	2,280,181	2,183,271
Debentures subsidy	90,160,057	75,591,167	59,900,471	43,001,592	24,801,500
Administrative fee	13,549,959	14,227,457	14,938,830	15,685,772	16,470,061
Funded loss reserve	58,804,499	63,332,446	68,209,044	73,461,140	79,117,648
	165,111,999	155,638,161	145,429,735	134,428,685	122,572,482
Remaining balance	538,996,758	494,940,671	462,975,955	445,379,249	444,717,465
COSBI debentures issued	653,383,324	703,693,840	757,878,266	816,234,892	879,084,979
Cumulative debs.	8,879,140,799	9,582,834,639	10,340,712,905	11,156,947,797	12,036,032,776
Pref. outstanding	76,362,996	76,362,996	76,362,996	76,362,996	76,362,996
Cumulative pref.	103,559,190	102,757,925	101,990,714	101,256,110	100,552,726
	179,922,186	179,120,921	178,353,710	177,619,106	176,915,722
Calls on pref.	3,434,314	3,288,356	3,148,601	3,014,785	2,886,657
Accrued dividends	1,030,294	986,507	944,580	904,436	865,997
	4,464,608	4,274,863	4,093,181	3,919,221	3,752,654

	2033	2034	2035	2036	2037
Assets					
Cash	538,996,758	494,960,671	462,975,955	445,379,249	444,717,465
Preferred rec.	179,922,186	179,120,921	178,351,710	177,619,106	176,905,722
Funded loan rec.	799,122,671	862,655,117	930,664,161	1,004,125,301	1,083,252,949
Pref. div. rec.	16,390,076	16,366,039	16,343,022	16,320,984	16,299,883
Total	1,534,431,691	1,552,882,748	1,588,336,848	1,643,444,640	1,721,176,019
Liabilities					
Deb. subs. payable	204,149,966	128,558,799	68,658,328	25,656,736	855,236
Trust balance	1,330,281,725	1,424,323,949	1,519,678,520	1,617,787,904	1,720,320,783
Total liab. & balance	1,534,431,691	1,552,882,748	1,588,336,848	1,643,444,640	1,721,176,019

The **Chairman**. Mr. Wilkins, thank you very much for your testimony.

I am fascinated by your introductory story. Is that a typical experience? Would you say the cable experience in Newark, is that typical insofar as a minority enterprise seeking funds in the capital markets?

Mr. **Wilkins**. It is very typical. We have a similar system that is under construction right now in the City of Los Angeles that is Hispanic owned. It is the only major market Hispanic-owned cable TV franchise in America, and we have gone through hell and high water financing that company. It has not been easy.

There is still aloft in this country the general perception that somehow minorities do not know how to run businesses, and, for that reason, venture capital companies with traditional mainstream funds will not provide capital unless it is almost under duress to minority communities, and I think all you have to do is walk through the city of Washington and look at the number of major minority-owned businesses there are right here in the Nation's Capital: There are none.

The **Chairman**. I gather, COSBI aside, that the MESBIC Program, its continuation, is absolutely essential, if there is to be economic opportunity in the minority communities. Is that the essence of what you are saying?

Mr. **Wilkins**. Yes.

The **Chairman**. I may have further questions for you, Mr. Wilkins.

Mr. Noojin, there are some at OMB and CBO who view the sale of any Government-guaranteed securities as not producing any savings since there is a contingent liability of the Federal Government. Consequently, from a budgetary point of view, the SBIC portfolio may have to be sold without recourse.

Do you think COSBI can work if the SBIC portfolio is to be sold on a nonrecourse basis, and how much would COSBI be willing to pay for the portfolio if sold without any guarantee?

Mr. **Noojin**. The subsequent panel, Mr. Chairman, will testify directly to that issue. They are from the investment banking community.

NASBIC's position is that COSBI will work if the portfolio has to be purchased without the Government guarantee. In terms of how much can be paid for the existing portfolio remains an open question, and we would have to have expert advice relative to that valuation. But, without the guarantee, I believe Mr. Stockman, in this very committee, proposed that that portfolio be sold for 19 cents on the dollar, was his estimated yield.

We think it would be significantly more than that, although less than par.

The **Chairman**. Mr. Wilkins, how would the MESBIC trust be funded if you were to sell the portfolio on a nonrecourse basis?

Mr. **Wilkins**. There are some concerns. We would, of course, propose, to the extent that there were any gains derived over and above those projected as necessary to meet savings targets, that they go to provide the funding as is proposed now.

We would also consider the continuation of the appropriation for the industry as it exists right now. The industry, the MESBIC industry, is getting some $44 million or $45 million a year. We would suggest that the appropriation, to meet the $100 million amount, be continued over some 2- to 3-year period, coming out of the same appropriations stream that exists and has been set aside presently.

The CHAIRMAN. I have further questions for response to the record.

I want to thank both of you for your appearance here today and again request of you that you get the word out there and hopefully we can get sufficient grassroots support in furtherance of this particular effort.

As you can tell from the answer of Mr. Turnbull, I reiterate that it is not just a question of opposition to COSBI; he gave you the clear-cut word they would like to eliminate MESBIC and SBIC, and they still want to go ahead and eliminate them. So, that is why I said before: I have got plenty of fights on my hands, and not many of them have been concluded in this area.

What worries me is that I have received a lot of support from colleagues, certainly on this committee, certainly on the floor. But this is an election year, and they are sensitive to the demands of small business communities, and I just would hope that support will continue after we get through the election year and into next year, because I have already been put on notice that OMB is going to come running right in again with the Small Business Administration and all of its ramifications within those aspects which you represent here today.

I suppose as much as anything the thing I like about COSBI is sometimes that if you turn it around, the best defense is an offense, and that is what we are doing in terms of this legislation.

I thank you both very much.

Mr. NOOJIN. Thank you.

[Subsequent information was received and follows:]

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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August 28,1986

The Honorable Lowell P. Weicker, Jr.
Chairman, Senate Committee on Small Business
248A Russell Senate Office Building
Washington, D.C. 20510-6350

Dear Chairman Weicker:

Enclosed are my answers to the supplemental questions you forwarded to me following the Committee's hearing on S. 2647, a bill which would create the Corporation for Small Business Investment (COSBI).

You also indicated that if I had further comments concerning the hearing, I could submit them in writing for the record. Although my oral and written testimony addressed most of the substantive and policy issues raised by the Administration, I would like to comment briefly on the testimony of Robert A. Turnbull, SBA's Associate Deputy Administrator for Management and Administration, and Mary F. Wieseman, SBA's Inspector General. These comments are enclosed as well.

Once again I would like to take this opportunity to thank you for your support in introducing S. 2647 and for your leadership and initiative in holding this hearing on COSBI, which is so vital to the future of the SBIC industry. We look forward to working with you and the other members of the Committee to make COSBI a legislative reality.

Sincerely,

J. Thomas Noojin
Chairman

RESPONSE TO THE COMMITTEE'S QUESTIONS ON COSBI

1. Question -- There are some at OMB and CBO who view the sale of any government-guaranteed securities as not producing any savings since there is a contingent liability of the federal government. Consequently, from a budgetary point of view the SBIC portfolio may have to be sold without recourse. Do you think COSBI can work if the SBIC portfolio is to be sold on a non-recourse basis? How much would COSBI be willing to pay for the portfolio if sold without any guarantee?

Answer -- First, I would like to point out that OMB and CBO are clearly wrong in their assessment that the sale of the $1 billion SBIC portfolio held by the Federal Financing Bank (FFB) to COSBI, with the government guarantee intact, would not produce any savings to the Federal Government. Their argument is based on fallacious reasoning that simply because the government's contingent liability remains no savings will result. It is further based on the faulty assumption that there will be a 100 percent default rate on the Federal guarantee, which is simply preposterous!

If the government is going to sell its assets -- which the Administration has firmly established it wants to do -- the real question is whether the government benefits more from the sale of its loan portfolio "with" or "without" the government guarantee. And clearly the government would lose hundreds of millions of dollars by selling the SBIC loan portfolio on a non-recourse basis! Let me give you an example. Although the investment bankers on Wall Street, with whom we have worked very closely, have advised us that until they can make a complete evaluation of the FFB-held SBIC portfolio, it is virtually impossible to give an accurate assessment of what this portfolio would bring if sold in the private capital markets on a non-guaranteed basis. They have indicated, however, that "ballpark figures" might generally range in the area of $.50 to $.60 on the dollar. Using the higher estimate, this means that the current SBIC portfolio held by FFB would sell for approximately $600 million if sold on a non-recourse basis. If this same portfolio were sold to COSBI "with recourse," it would bring in $1 billion in cash!! Assuming an ultimate loss rate on SBIC guaranteed debentures of six percent (which is very conservative based on historical data), the government's contingent liability exposure on this portfolio would be about $60 million. Therefore, the government would lose some $340 million by selling the SBIC portfolio on a non-recourse basis!! And, this does not take into consideration the present value of having $1 billion "cash in hand" which the government can either invest, and earn interest on, or use to reduce the Federal debt. Nor does it take into consideration that the Federal Government no longer will have to support the SBIC Progam with $250 million in government guarantees each year. (Over the next 50 years this would account for some $12.5 billion in new government guarantees.) Nor does it consider the savings generated from no longer having to finance the MESBIC Program at a level of $50 million annually. (Over a 50 year period this is a savings in direct cash outlays by the Federal Government of some $2.5 billion.)

We agree entirely with the statement made by the Committee that "if the purpose of reconciliation is deficit reduction, it is in the government's best interests to maximize its receipts from the sale of assets. It would be a waste of public assets to sell loans at a deep discount required by the market under a non-recourse sale."

Finally, I would simply like to emphasize that these savings would be real "cash in hand savings" to the Federal Government and do not in any way address the economic benefits that the Federal Government would gain in terms of economic growth and increased revenues that would be generated through COSBI, which we believe would increase the flow of venture capital to small firms by hundreds of millions, and perhaps billions, of dollars.

AS to whether COSBI would work if the SBIC portfolio were sold to it on a non-recourse basis would obviously depend on the terms and conditions of the sale of the portfolio to COSBI. The investment banking community has advised us that it is possible for COSBI to work with the purchase of the SBIC portfolio on a non-recourse basis. Some investment bankers are more sanguine than others, as noted in the difference in testimony of the two investment banking firms that testified at the Committee's hearing on COSBI. If the government were to permit the sale of its assets only on a non-recourse basis, however, the SBIC industry, in conjunction with experts in the financial marketplace and the Committees of the Senate and the House, would take every feasible step and make every effort to find a way to make COSBI work on such a basis. What price COSBI could pay for the portfolio if sold without any guarantee, and the terms and conditions of such a sale, would be determined based upon those findings.

2. Question -- What type of access will COSBI have to the books, papers and financial records of the individual SBICs? How will COSBI enforce the contractual undertakings linking it with individual SBICs?

Answer -- COSBI will have complete access to the books, papers and financial records of each SBIC. Furthermore, COSBI will exercise diligent oversight to ensure that each SBIC maintains the necessary books and records to enable COSBI to ensure that the SBIC is in full compliance not only with the legislation enacted by Congress but also with the rules and regulations that COSBI will adopt.

As I noted in my testimony, the contractual agreements between COSBI and each SBIC will set forth the operating standards that each SBIC must comply with in order to continue to operate. Failure of an SBIC to adhere to those criteria will subject the SBIC to suspension or revocation of its qualification to conduct business with COSBI. Furthermore, COSBI will be able to take every appropriate legal action to ensure compliance, including the ability to accelerate all obligations due to COSBI, assessment of penalties against the SBIC or its officers or directors, and suspension or termination of agreements between the Corporation and the SBIC. It will include audits, examinations by COSBI employees, certifications of compliance by independent CPA firms, a timely review of financial reports, civil litigation where necessary, and referrals to the Justice Department in cases involving possible criminal activities. In cases where COSBI must move quickly to protect its interests, it can do so through pursuing such civil remedies as temporary restraining orders, injunctions, attachment of assets, and the like. This system will be substantially better and more efficient than the one currently administered by the Office of the Inspector General which recently concluded that it "can no longer perform the annual examination function of the SBIC program without neglecting the other audit responsibilities which we have under the Inspector General Act."

Attached as an exhibit to this response is a copy of the Inspector General's memorandum.

3. Question -- Do you think that there is a public purpose involved in COSBI and do you think that it will be adequately protected if the SBA does not have access to the individual books and papers of the SBICs?

Answer -- As a government sponsored enterprise there is a clear and obvious public purpose involved in COSBI since it will replace the Federal Government as a source of financing for, and regulator of, the SBIC industry which as been the Nation's primary source of venture capital financing for small businesses. Although COSBI will continue ad infinitum to foster growth and stability in the SBIC industry, during each of the ten years following enactment of COSBI (assuming a sale of the FFB-held portfolio to COSBI with recourse) the government's financial exposure will decrease substantially until it no longer has any contingent liability remaining in the government guaranteed debentures. Even though the government's financial risk will decrease, and will eventually terminate except for the "backstop" of the U.S. Treasury, the public purpose of COSBI will not. This public purpose will more than adequately be protected through COSBI's operations. (See answer to question #2 above.)

3(a) Question -- S. 2647 provides for the SBA to have "review authority" over COSBI. What is understood by that term? Will the SBA, Congress, or the Office of the Inspector General be able to get access to the books and financial records of an individual SBIC if there appears to be a need?

Answer -- SBA's "review authority" means that it will have the authority to examine COSBI's criteria for qualification of SBICs to conduct business with the Corporation and its rules and regulations governing the operations of SBICs. SBA will also have the authority to examine COSBI's books and records and may require it to provide reports of its operations. SBA's review authority, however, would stop at the level of COSBI and would not extend to the operations of individual SBICs. Congress, in its oversight capacity, and the GAO if requested by Congress, would have the authority to get access to the books and financial records of individual SBICs if there appears to be a need.

4. Question -- What do you think will be your annual capital needs, and how often do you think COSBI will be issuing securities to the capital markets?

Answer -- COSBI will be in a position to become operational once it has raised an initial $15 million in capital through the common stock offering to SBICs. These proceeds will provide a sufficient capital equity base to provide working capital for COSBI and to support COSBI's initial borrowing activities. Within a year thereafter, COSBI will issue its own securities in order to raise sufficient capital to purchase the $1 billion FFB-held portfolio.

Once COSBI has taken the action noted in the above paragraph as required by law, it will offer its securities to the capital markets on an "as needed" basis in order to provide financing to the SBIC and MESBIC industry at a level at least equal to current law authorizations -- approximately $300 million per year.

5. Question -- The ultimate loss rate of SBICs is approximately 6% on their debentures. Under COSBI, if there were a default by an SBIC, how would COSBI go about collecting?

Answer -- Assuming that COSBI were unable to work out an arrangement with a defaulting SBIC to cure the default on its obligation, and was forced to institute collection proceedings, COSBI would avail itself of whatever civil remedies remedies were required in order to collect on the obligation owed to it. (See answer to question #2 above.)

6. Question -- OMB has objected to COSBI as yet another in the growing number of government-sponsored enterprises. OMB points out that in 1985 government-sponsored enterprises absorbed one out of every 8 dollars raised in the U.S. credit markets. How do you respond to OMB's argument that COSBI would contribute to the squeezing out of non-subsidized credit, thereby raising the costs of all American small businesses except those that borrow from COSBI?

Answer -- OMB's "credit allocation" argument is one of the arguments the Administration has frequently used during the last two years to justify its proposal to eliminate not only the SBIC Program but all of the financial assistance programs at SBA. The new wrinkle in their argument is that because the same financing currently provided to SBICs through the SBA program will be provided through COSBI, a government-sponsored enterprise (GSE), it is somehow worse!! OMB mistakenly believes that its argument to eliminate this critical source of venture capital financing for small business somehow gains merit with COSBI, since it can lump a $250 million annual credit allocation in with the credit allocation of other GSEs, such as the $88 billion portfolio held by the Federal National Mortgage Association -- presumably to make the impact on the credit market seem greater than it really is! Nevertheless, whatever negligible impact the $250 million program level for the SBIC Program currently has on the Nation's total credit market, if any, will be exactly the same after enactment of COSBI as before.

Furthermore, OMB incorrectly assumes there are others in the credit markets who provide the same venture capital financing to small businesses that the SBIC Program provides, and that the SBIC Program competes with those other sources of financing. That is simply wrong!! The SBIC Program, as the Committee is well aware, provides venture capital to small business that is simply not available from any other source! SBICs have accounted for about ten percent of all venture capital provided to the Nation's businesses -- and all to small businesses!! The average size of an SBIC financing is a little over $157,000, whereas the average size of the non-SBIC venture capital financing is closer to $3 million. SBICs invest their dollars where other venture capitalists won't and in virtually every geographic section of the country. This means that if SBIC financing is not available, the likelihood of the same small firm obtaining other similar types of long-term, growth capital is virtually nil. When small businesses are assisted financially through an SBIC, the impact is to foster economic growth, create new jobs and new technology, and generate new revenue far beyond the cost of the program, or any theoretical credit cost.

We would agree with the observations made by Senator Weicker during the hearing on the threat of increasing economic concentration in the United States. NASBIC believes that the limited Federal backing for the SBIC Program under COSBI represents an almost imperceptible amount of "government intervention in the private capital markets." To object to passage of COSBI on such ideological grounds ignores completely the crucial role SBICs play in revitalizing the entrepeneurial segment of our concentrated national economy.

ADDITIONAL COMMENTS ON THE ADMINISTRATION'S TESTIMONY ON S. 2647

Response to recommendations of Robert A. Turnbull, SBA Associate Deputy Administrator for Management and Administration:

1. Recommendation -- COSBI should be able to call upon Treasury's contingent lending authority (the "backstop") only to protect COSBI's creditors and it should not be available to provide additional funds to SBICs or to subsidize their borrowing costs.

Answer -- SBA's recommendation shows a complete lack of understanding of the backstop authority contained in S. 2647. First, the legislation does not give COSBI any authority whatsoever to call upon the Treasury backstop authority -- at any time or under any circumstances!! If COSBI were to request such assistance, the Secretary of Treasury, upon considering the request, would have the sole authority to make the initial determination that the government should utilize this backstop authority. Furthermore, in the unlikely event the Secretary were to decide to trigger this backstop authority, the legislation gives the Secretary authority to impose whatever restrictions and limitations he deems appropriate regarding its use. Thus, if the Secretary were to make the initial determination that it was necessary to utilize this backstop authority to assist COSBI, not only could he restrict the use of Treasury funds for the purpose of protecting COSBI's creditors, but he could also impose whatever additional restrictions he deemed appropriate under the circumstances.

As important, this backstop authority could be utilized, and would be available, only if Congress were to agree with the determination of the Secretary of Treasury. Congress must pass legislation specifically approving and appropriating funds for this purpose before one dime of the government's money could ever be spent! In passing such legislation, Congress could certainly impose whatever additional restrictions it thought necessary in order to protect the government's interests.

As I discussed at length in my prepared testimony to the Committee, this backstop provision is essential to ensure the viability of COSBI!! It is key in order to ensure that the investing community will view securities issued by COSBI as investment grade "agency" securities for pricing purposes. Without this backstop, the sale of COSBI's securities would be either virtually impossible or the pricing so extreme that COSBI's feasibility would be very questionable. Clearly, the purpose of this backstop is not to provide additional funds to SBICs or to subsidize their borrowing costs, as SBA has suggested. That is a misinterpretation of this legislative provision. Nevertheless, if the Committee believed it necessary to clarify the statute in this regard, such a clarification would be entirely acceptable to the SBIC industry.

2. Recommendation -- New language should be added to COSBI to make SBIC obligations held or guaranteed by the government senior to any SBIC borrowings from or obligations guaranteed by COSBI.

Answer -- Under an SBA regulation that has remained virtually unchanged throughout the 28 year history of the program, when SBA guarantees an SBIC's debenture, SBA subordinates its claims against the debenture (unless it specifically determines otherwise -- which it has not done in at least the last 10 years) to all other debts of the SBIC. This means that SBA has agreed to take a secondary position to all of the SBIC's other creditors; that is, in the event of default, SBA has agreed that the government's right to collect on its obligation will take a back seat to all of the SBICs' other obligations. The Turnbull proposal (which obviously assumes the purchase of the FFB-held portfolio with recourse) would reverse this 28 year policy position!!

Furthermore, by granting the government a senior lien position, COSBI and the marketplace investing in COSBI securities would be placed in the position of having to underwrite and guarantee the credit judgment of SBA when it issued the guarantee, and this makes no sense at all!! When COSBI becomes operational, it will be more than willing to assume the risk of its own credit judgments; however, COSBI should not be required to guarantee the credit judgments of SBA first -- even before its own obligations. It would be disruptive to COSBI's credit position in the capital markets, increase COSBI's cost of borrowing, increase the cost of funds to SBICs and increase the cost of money to the small business. COSBI should, and is willing to, stand by its own losses based on its own credit judgments, but it should not be asked or expected to underwrite the losses generated because of poor credit judgment by the government.

3. Recommendation -- COSBI should be required to establish a funded loss reserve to reimburse the government for its aggregated losses. Furthermore, COSBI should be prohibited from making any distributions, or paying any dividends on its voting common stock, or repurchasing any of its voting common stock until it has fulfilled its obligations under this funded loss reserve provision.

Answer -- Again, this funded loss reserve proposal would require COSBI to guarantee and underwrite the credit judgments made by SBA when it issued the government guarantee! That is, COSBI would be expected to pay the government for losses incurred as a result of credit decisions and judgments made "on its watch." This would not be appropriate. (See answer to question #2 above.)

As to SBA's suggestion that COSBI should be restricted from making distributions for a period of time, it is certainly true that in normal business circumstances, prudent businessmen would not permit an institution to pay dividends before it has demonstrated financial viability. On the other hand, a restriction such as the one proposed by SBA on COSBI's ability to make distributions, pay dividends, or repurchase its stock, before paying off defaults resulting from government action, is an artificial restriction based on events beyond COSBI's control. The result would be to penalize COSBI and inhibit its ability to raise money and provide financing to SBICs. Investors, seeing this type of restriction, would be reluctant to purchase COSBI securities knowing that COSBI had to pay for the government's losses before it could offer a return to its own investors. In short, such a proposal would devastate COSBI's ability to issue securities and raise money in the marketplace.

Response to recommendations of Mary F. Wieseman, SBA Inspector General:

1. Recommendation -- SBA and the Inspector General should have general regulatory authority.

Answer This recommendation was addressed fully in my prepared testimony, in my testimony before the Committee and in my response to the Committee's questions.

I must emphasize again, however, that SBA's position is an unfortunate and misguided attempt to undermine the fundamental concept of privatizing the industry through COSBI. If SBA continued to regulate SBICs, we would be left with a two-track system far more confusing and less efficient than the one currently in place. If SBICs continued to be subject to the independent regulatory intervention of SBA, COSBI would become a powerless, ineffective financial intermediary, whose financial condition would continually be jeopardized by change in SBA's regulatory policies. Under these circumstances, no sound-thinking SBIC or MESBIC would invest in COSBI's stock or participate in the program. This type of uncertainty would destroy COSBI's ability to issue securities in the capital markets; and the concept of privatizing the SBIC program through a capital bank first advocated by Congress some 19 years ago would be thrown back into a state of paralysis.

The regulatory system provided by S. 2647 is a far better answer. It is a reasonable approach that provides a responsible role for SBA, ensures oversight by the Congress, Secretary of Treasury and General Accounting Office, and protects the public purposes of the Act and small businesses. At the same time, it creates an improved operating environment in which SBICs can effectively serve the financial needs of small business, and it provides a system that will allow COSBI to operate effectively in the capital markets.

2. *Recommendation* -- SBA and the Inspector General should have the authority to obtain copies of all audit reports on COSBI and the SBICs and have access to workpapers supporting all such audits.

Answer -- Under S. 2647, SBA and the Inspector General would have the authority to obtain copies of all audit reports on COSBI. (See Subsections (a) through (e) of Section 360 of the bill.) As to audit reports of individual SBICs, this would clearly be prohibited. (See answer #1 above.)

3. *Recommendation* -- SBA and the Inspector General should have the authority to audit the books and records of COSBI, participating SBICs and small business concerns financed by the SBICs.

Answer -- It makes little sense to give the Inspector General more authority to perform additional audits when it does not have the staff or resources to perform its current audit responsibilities. As noted previously, the Inspector General recently concluded that "the OIG can no longer perform the annual examination function without neglecting the other audit responsibilities which we have under the Inspector General Act."

Clearly, the solution for ensuring that the SBIC program under COSBI performs in accordance with Congress' intent is not to implement a regulatory framework that would impose new responsibilities on an OIG that is unable to perform its current audit responsibilities! The solution is to have these audit responsibilities performed by an independent certified public accounting firm, as S. 2647 would mandate. Although the OIG did not support this method of oversight of COSBI in its testimony before the Committee, this is precisely the solution that it recommended to resolve its own staffing and budget problems. *As* the OIG concluded further in its memorandum, "(I)t is our view that the best way to approach this matter is to require SBIC's to obtain a compliance audit annually by an independent public accountant." We agree!! Consistent with the OIG's recommendation that an independent certified public accountant be used to perform the audits of individual SBICs, wouldn't an independent certified public accounting firm also be the far better method of ensuring timely and effective audits of COSBI!! And, given the constraints under which the OIG already works, certainly such an independent public accounting firm would be far more qualified and better able to do the job expected by Congress.

Although the OIG also requested authority to audit small business concerns financed by SBICs under COSBI, it neglected to point out that it does not have that authority under current law! Since most small firms simply don't have the time or resources to devote to extensive government regulations and paperwork, Congress, in its wisdom, did not impose this additional burden on small business concerns financed by SBICs. The OIG's recommendation, if anything, is simply indicative of the sort of overreaching that has caused the SBIC industry so much concern with the regulatory structure now in place at SBA. It is the sort of recommendation which, when coupled with the OIG's other recommendations, would drive SBICs away from COSBI, and create havoc in the SBIC Program. It would represent a step in the opposite direction of privatization, and would achieve what the administration has not yet been able to accomplish -- as so eloquently stated by Senator Bumpers -- "that the SBICs be taken out back of the Capitol and shot."

Once again, I would like to emphasize that COSBI has every possible incentive to be a strict regulator of the SBIC program and avoid even the appearance of regulatory abuses. COSBI's motivation is simple -- if it doesn't operate efficiently and free of abuses in providing risk capital to small business, it will not succeed. Indeed, to harness the tremendous potential that has only surfaced in the first 28 years of the program, COSBI must do a far better job than SBA has done in providing financial assistance to and regulating the SBIC industry. That is what Congress expects, and that is what COSBI intends to do.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE INSPECTOR GENERAL

Date: JUL 18 1986

To: AA/Finance & Investment
AA/Investment Division
General Counsel

From: Inspector General

Subject Proposed Revision of SBIC's

This is a follow-up to our memorandum concerning a proposed revision to the Small Business Investment Company examination process. As that memorandum explained, we believe that, given staffing and budget constraints, the OIG can no longer perform the annual examination function without neglecting the other audit responsibilities which we have under the Inspector General Act.

In our meeting on this subject, we discussed various ways to address this problem. Since that time, we have talked with personnel in the Investment Division and within the OIG. It is our view that the best way to approach this matter is to require SBIC's to obtain a compliance audit annually by an independent public accountant. This audit would be performed in accordance with an audit program developed by SBA, and subject to review by the OIG. We would reserve the right to audit any company which we selected.

This new procedure will require a regulatory change. We will be developing proposed language for such a regulation which we will forward for your consideration.

If you have any questions on this, please let me know.

Mary F. Wie

Mary F. Wieseman

The **Chairman**. We now have Mr. Miner Warner, vice president and manager, Government finance, Salomon Bros., New York, and Mr. Michael Clare, vice president of finance, Citicorp Investment Bank, of New York.

Mr. Warner and Mr. Clare.

Mr. **Clare**. Mr. Chairman, would you mind if my colleague, Henry Edelman, joins me at the table?

The **Chairman**. I would be delighted if your colleague would join you.

Mr. **Clare**. OK. Thank you.

The **Chairman**. Joining us now is the ranking member of the Small Business Committee, Dale Bumpers, and since it is probably one of the last hearings that we have during the course of this particular legislative session, I would like to say that whatever the committee has done—and it has done considerable—is due in large measure to his efforts and those of his Democratic colleagues which he leads. I want to thank him for it.

As well as I wish him, I would still hope that he would be no more than the ranking member when the next session commences. [Laughter.]

The **Chairman**. In any event, Dale is with us, and I am glad to acknowledge the tremendous contribution which he has made.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator **Bumpers**. Mr. Chairman, I thank you very much for those kind words, and I must say that I doubt that there is a committee in the Congress—in the Senate, anyway—where the chairman and ranking member have a better working relationship than the Chairman and I have had on this committee. I like to believe that that redounds to the benefit of both the country, and especially the small business community.

When we have differences, they are honest, and they are agreeable, and we work them out as best we can. If we have to, we work them out on the floor. I could not ask for better cooperation and spirit of camaraderie than I have had out of the chairman.

Now that the mutual admiration society is adjourned, we will continue.

The **Chairman**. And I will now leave the chairing—I have another committee hearing to attend, myself—the chairing of the session to Senator Bumpers.

The first witness is Mr. Warner, vice president and manager of Salomon Bros.

Senator **Bumpers**. Mr. Chairman, I ask unanimous consent that a statement I have, be inserted in the record prior to the beginning of the hearing.

The **Chairman**. Without objection, so ordered.

[The prepared statement of Senator Bumpers follows:]

STATEMENT OF

SENATOR DALE BUMPERS

AUGUST 7, 1986

MR. CHAIRMAN, I WANT TO COMMEND YOU FOR CONVENING THIS HEARING ON S. 2647, WHICH I WAS PLEASED TO JOIN YOU IN INTRODUCING ON JULY 16. AS YOU KNOW, WE ESSENTIALLY TOOK THE HOUSE BILL, WHICH WAS THE PRODUCT OF SEVERAL MONTHS' WORK AND DEVELOPMENT, AND INTRODUCED THIS BILL IN THE FORM IN WHICH IT WAS REPORTED FROM THE HOUSE SMALL BUSINESS COMMITTEE. THIS IS, I MIGHT ADD, ONE OF THE MORE INNOVATIVE PROPOSALS FOR SMALL BUSINESS FINANCE WHICH HAS BEEN CONSIDERED IN THE CONGRESS IN THE TIME I HAVE SERVED ON THIS COMMITTEE.

OUR BILL WOULD CREATE A NEW, GOVERNMENT-CHARTERED BUT PRIVATELY-OWNED CORPORATION WHICH WOULD PURCHASE THE SMALL BUSINESS INVESTMENT COMPANY DEBENTURES WHICH ARE CURRENTLY PURCHASED BY THE FEDERAL FINANCING BANK. SO COSBI HAS THE VIRTUE OF ENTIRELY REMOVING ANY FEDERAL GUARANTY OF SBIC DEBENTURES.

THE SBIC PROGRAM FILLS A VITAL NEED FOR VENTURE CAPITAL FOR SMALL BUSINESS IN AMERICA. MOREOVER, THE SBIC INDUSTRY HAS HAD MANY OUTSTANDING SUCCESSES OVER THE YEARS--APPLE COMPUTER, NBI, DIGITAL SWITCH, NIKE, FEDERAL EXPRESS, AND MANY OTHERS--WHICH HAVE CREATED THOUSANDS OF JOBS AND PAID MILLIONS OF DOLLARS IN FEDERAL TAXES. THE INDUSTRY HAS MATURED OVER THE YEARS, AND A GOOD ARGUMENT CAN BE MADE THAT THEY SHOULD HAVE A BIT MORE

CONTROL OVER THEIR OWN DESTINIES. AT THE VERY LEAST, I AM VERY SYMPATHETIC TO THEIR FRUSTRATION WITH THE VICISSITUDES OF THE ANNUAL APPROPRIATIONS AND AUTHORIZATIONS STRUGGLES AND WITH PRESIDENTS WHO ANNUALLY PROPOSE THAT THE SBIC'S BE TAKEN OUT BACK OF THE CAPITOL AND SHOT.

THE ADMINISTRATION GIVES LIP SERVICE TO "PRIVATIZATION", BUT I RECEIVED A LETTER YESTERDAY FROM OMB DIRECTOR JIM MILLER STATING THEIR OPPOSITION TO THIS BILL. MY CHIEF QUESTION FOR SBA AND FOR OMB WILL BE TO SPECIFY EXACTLY WHAT THEY MEAN BY PRIVATIZATION. WHAT DO WE NEED TO DO TO THIS BILL TO SATISY OMB. I WILL BE HAPPY TO CONSIDER ANY PROPOSAL BY THE ADMINISTRATION, BUT I SUSPECT THAT WE REALLY SHOULD READ "ELIMINATION" WHEREVER THEY SAY PRIVATIZATION.

THERE ARE, HOWEVER, STILL A NUMBER OF IMPORTANT ISSUES IN THIS LEGISLATION WHICH SENATORS NEED TO CONSIDER CAREFULLY. PERHAPS THE MOST IMPORTANT OF THESE IS WHETHER THE PUBLIC INTEREST IS ADEQUATELY PROTECTED BY TURNING THE REGULATORY FUNCTION AND THE AUDIT FUNCTIONS NOW CARRIED OUT BY SBA OVER TO COSBI. I CAN ONLY SAY THAT I LOOK FORWARD TO HEARING THE TESTIMONY OF ALL THE WITNESSES TODAY, AND THAT, TO MY WAY OF THINKING, THE JURY IS STILL OUT ON THE REGULATORY ISSUE. THE HOUSE HAS HELD SEVERAL DAYS OF HEARINGS ON THIS LEGISLATION AND GONE THROUGH MANY DRAFTS OF THE BILL. I BELIEVE THIS COMMITTEE CAN FURTHER IMPROVE ON THE HOUSE'S WORK, AND THAT WE OWE IT TO THE SBIC INDUSTRY TO GIVE IT OUR BEST EFFORTS.

The CHAIRMAN. Mr. Warner.

STATEMENT OF MINER H. WARNER, VICE PRESIDENT AND MANAGER, GOVERNMENT FINANCE GROUP, SALOMON BROS., INC.

Mr. WARNER. Thank you, Mr. Chairman.

I would like to submit my testimony for the record and summarize my conclusions, please.

Senator BUMPERS [acting chairman]. The testimony of both Mr. Warner and Mr. Clare, in its entirety, will be included in the record.

Mr. WARNER. I have experience with the sale of Federal loan assets on a recourse basis and also with the introduction of new agency securities into the market, working back in 1981 with the reintroduction of the Student Loan Marketing Association, or Sallie Mae.

I would like to address myself just to two questions, Mr. Chairman.

First of all, whether or not the COSBI legislation does, in fact, create a new quasi-Federal Agency; and

Second, whether or not the SBIC debenture portfolio guaranteed by SBA and currently held by FFB should be transferred by purchase to COSBI with recourse or without recourse.

Quite emphatically, the proposed COSBI legislation does, in fact, create a new quasi-Federal agency. It has all the legal and investment characteristics of an agency. It has a discretionary line to Treasury, which, of course, is subject to congressional appropriations. It would be, by far, the smallest of the quasi-Federal agencies.

One estimate is that maximum outstandings in 1987 could probably be no more than $1.250 billion. That is put in the context of an outstanding quasi-Federal agency market of $250 billion today.

If COSBI were to take the SBIC SBA-guaranteed debenture portfolio, we are confident that, on the assumption that COSBI were properly introduced to the marketplace, that it would sell in price comparable to the yields of other quasi-Federal agencies.

If, however, the SBIC debenture portfolio is transferred without the SBA guarantee, in our judgment the pricing of the COSBI securities will be required to pay a premium over those of other quasi-Federal agencies of comparable maturity of anywhere from 25 to 50 basis points.

So, conclusion one is: Regardless, COSBI would be a quasi-Federal agency, and, as a quasi-Federal agency would always have access to the markets, but were the SBIC debenture portfolio to be transferred without guarantee, it would necessarily be required to pay a premium.

And why is that?

The reason for that is uncertainty as to the value of that portfolio. It is certainly possible that the portfolio could be valued at some notional or theoretical discount basis, but that would not really be at all comparable to a true market value of that portfolio.

I go on in my testimony, Mr. Chairman, to discuss certain of the consequences and characteristics of a nonrecourse sale of loan assets.

I would like to mention three areas of concern, and those pertain to what is the true default rate, what is the state of underlying loan documentation and recordkeeping, and, finally, the question of agency forebearance.

Frequently, in terms of agency recordkeeping, collection rates are the descriptive word. There is a different vocabulary on Wall Street than there is in Washington with the agencies. What Wall Street thinks of in terms of delinquencies and defaults can have a very different meaning down here.

I am familiar, for example, with some loan programs which have a negligible default rate, but that low default rate is because of forebearance. Under one agency default rates are negligible because, among other things, the agency has the right to permit the borrower to have a moratorium on all interest and principal payments.

If an agency permits a borrower to have a moratorium on interest and principal payments when due, it is awfully difficult to have a high default rate.

A second generic concern that we have in terms of the pricing of agency loan assets and also the SBIC debenture portfolio is the underlying state of the loan documentation, recordkeeping, and payment records. Again, on a true nonrecourse sale, loan documentation and recordkeeping is a key element in an investor's decision whether or not to make an investment.

I have already touched on agency policies of forebearance. I conclude my thinking in terms of nonrecourse loan sales by suggesting that only those loan assets which are characterized by a low or nonexistent default rate, whose loan files are complete and record-paying records are complete and comprehensive, also, and the policy of whose agency as lenders is not one of forebearance, can be realistically considered for true nonrecourse loan sales.

That eliminates, of course, many billions of dollars of loan assets, including many billions of dollars of SBA loan assets, but, in the context of the $250 billion of Government loans in portfolio, there are tens of billions of dollars of loan assets which do qualify.

Obviously, a transfer or sale with recourse, with SBA guarantee, does away with the need to have comfort in the default, recordkeeping, and forebearance areas.

For that reason, we say that a transfer of the SBIC debenture portfolio from the $150 billion FFB portfolio, without recourse, means that the value of that portfolio in COSBI's hands will be purely notional or theoretical and actually will not be reflective of market value.

We conclude, Mr. Chairman, by saying that the legislation which is proposed here creates a new quasi-Federal agency which will finance advantageously in the capital markets, and that on the basis of my discussion of the SBIC portfolio evaluation, we recommend that the portfolio be transferred from the FFB, with recourse, so as to lower the cost to COSBI on the sale of the securities to the public.

I thank you.

[The prepared statement of Mr. Warner follows:]

Testimony

By

Miner H. Warner

Vice President and Manager

Government Finance Group

Salomon Brothers Inc

On

S.2647

Corporation for Small Business Investment Charter Act

Before The

Senate Committee on Small Business

Washington, D.C. Thursday, August 7, 1986

1854p

My name is Miner H. Warner, and I am Vice President and Manager of the Government Finance Group at Salomon Brothers Inc. I have been involved with U.S. Government Agency and guarantee programs since 1971 when I first worked with William E. Simon, then at Salomon Brothers; subsequently Secretary of the Treasury, in connection with recourse loan sales, such as Farmers Home Administration insured block note and Certificate of Beneficial Ownership sales and Small Business Administration guaranteed SBIC debentures. In addition, I have had experience with the introduction of Agency securities to the marketplace, working with Student Loan Marketing Association (Sallie Mae) in 1981 following Sallie Mae's exit from the Federal Financing Bank. I am pleased to have this opportunity, Mr. Chairman, to appear before your Committee to testify in connection with S.2647, entitled "Corporation for Small Business Investment Charter Act".

I wish to address two questions:

A. Does S.2647 create a new quasi-Federal Agency.

B. Should the Federal Financing Bank SBIC debenture portfolio be transferred to COSBI with or without recourse.

A. In my judgment, S.2647 creates a new quasi-Federal Agency which will accordingly have access to the market on favorable terms.

Agency securities have become well-established in the marketplace particularly since the 1960's, and currently there is approximately $250 billion in outstanding direct Agency debt excluding Agency guarantees. The vast bulk of this debt is short to intermediate maturity with very little having a maturity of 10 years or greater. COSBI by far would be the smallest issuer with maximum expected FY'87 outstandings of not more than $1.250 billion.

S.2647 gives COSBI all the legal characteristics of a quasi-Federal Agency, including such key characteristics as broad investment eligibility for fiduciaries and exemption from registration with the SEC. In addition, there is the proposed discretionary line to the Treasury. If the FFB SBIC debenture portfolio were transferred with the SBA guarantee intact, COSBI would be quite analogous to Sallie Mae with its portfolio of guaranteed student loans. We are confident that COSBI could access the Agency market on favorable terms.

However, if the portfolio were transferred without recourse and at some notional discount, in our view, despite COSBI's quasi-Federal Agency status, the market will require a premium of betwen 25-50 basis points over the yield on other Agency securities of comparable maturity. The value of the portfolio would be viewed by investors with considerable uncertainty.

B. As noted, from a purely economic viewpoint, there are advantages to COSBI for the FFB portfolio to be transferred with recourse. As also noted, a transfer of the portfolio without recourse can be effected through a notional or theoretical discount of the portfolio which, however, would not be indicative of market rates. Market rates could only be determined through a nonrecourse sale of the SBIC debentures, and a basic question is whether such a sale is practical so as to develop a market value of the portfolio.

Both the Administration and Congress have approved substantial nonrecourse loan sales commencing in FY '87. The OMB loan sale guidelines dated July 8 indicate realistic directions for such sales. They are tens of billions of dollars of loans which can be structured and sold on a nonrecourse basis at values reflective of the high credit quality of the underlying loans. Consequences of such sales include:

1. privatization
2. dollar for dollar deficit reduction
3. diminished use of Federal credit
4. improved administration of loan procedures both at origination and in servicing
5. measurement of subsidies of loan programs.

The credit characteristics of COSBI's SBIC portfolio will be significantly different if the portfolio is transferred from FFB with the SBA guarantee intact than if transferred on a nonrecourse basis. A brief Federal loan and guarantee program review is in order.

At the beginning of calendar 1986, approximately $250 billion in guarantees was held in the private sector. In addition FFB held additional loan assets of $150 billion, of which approximately $50 billion were denominated as guarantees.

OMB has also reported that there are $250 billion in direct loans originated under various Executive Branch Agency and Department programs and which are held in government portfolios. There is some overlap between these Agency loans and loans financed through the FFB in the form of Certificates of Beneficial Ownership. CBO's are financed with full recourse through FFB.

To analyze whether loans can be sold for reasonable value without recourse, it is necessary to examine the underlying credit history of particular Agency programs. In testimony given before the Senate Governmental Affairs Committee on May 13, 1986, I concluded the following:

" 1. In order to maximize value it will be necessary to sell creditworthy loans on an individual program by program basis. Loans originated under different programs and different Agencies cannot be mixed together.

2. Agencies which administer the loan program, not Treasury, should have primary responsibility for the sales.

3. Loans must be packaged and not sold individually. The negotiated sale method, not the auction method, will maximize value to the Government.

   Only credit enhanced structured financings will be able to obtain investment grade ratings. Without structuring and ratings, packages of loan assets, despite underlying creditworthiness, will be accorded junk bond treatment and be sold at fire sale prices.

4. Third party servicing is available for creditworthy loans."

Unless certain criteria are met, nonrecourse sales will result in subjunk or fire sale prices.

Key additional criteria are:

1. default rate
2. loan documentation and record keeping
3. Agency policies of forebearance

1. Default rates differ enormously within Agencies. I am familiar with one Agency, for example, which has a 43% delinquency rate on loans generated in one program and less than 1% delinquency rate in another program. This is not surprising. One program is really a grant program and perhaps should be called such. The other is more nearly run along commercial lines.

The terms default and delinquency rate have different meanings in government loan programs than in the private sector. The collection rate, which is ultimately established following default, is frequently used as a measure of a program's credit cost.

Only loan programs with low default rates can be packaged, and once packaged, are ratable by the rating agencies, and saleable to investors at interest rates which reflect current market conditions.

2. True nonrecourse loan sales require the transfer of underlying loan documentation to third party servicers. Investors look to such documentation and to loan payment histories in order to make an investment decision. While the foregoing may seem self evident, the condition of loan documentation and recordkeeping is a recognizable hurdle for loan sales by certain Agencies.

3. Some Agencies act as benign lenders, exercising forebearance with delinquent borrowers. Borrowers under certain programs can reasonably and justifiably expect forebearance from Agencies in the event of delinquency given regulations or customary usage in effect at the time of a loan. Forebearance can include a moratorium on all payments due. Forebearance is frequently reflected in the low default rates of some loan programs. Obviously, nonrecourse loans in the hands of a third party investor could have a different and materially higher default rate than in the portfolio of a benign Agency lender.

Whether to sell loans on a nonrecourse basis can be a function of the underlying credit quality of the loans, but the mixed credit quality of many loan programs should preclude sales except with recourse in whole or in part.

If the true delinquency and default rates are low, documentation complete, and borrowers not entitled to expect Agency forebearance in the servicing of their loans, packaging of loans can be accomplished so as to obtain ratings from the rating agencies. The importance of ratings cannot be overemphasized. Given investment grade ratings, packages of nonrecourse loans can be broadly marketed to the full universe of investors in investment grade securities. The absence of ratings dramatically reduces the size of the available market. To the extent that loan packages are not rated by reason of significant default rates, such loans would be sold at subjunk or fire sale prices. Junk or high yield debt investors would be uninterested in such loans as such investors do not intentionally invest in credits in which there is a probability of default. In many loan programs, the question is not whether there will be defaults but rather, how many, and whether that amount would increase in the absence of Agency forebearance. It is difficult to identify likely purchasers of subjunk debt.

Clearly, the transfer of the FFB SBIC portfolio with the SBA guarantee cures the three major generic concerns -- default rate, documentation, and forebearance -- of nonrecourse loan sales. In addition, the rating process is unnecessary given the "full faith and credit" nature of the SBA guarantee. Finally, full value is received by the Government as the major concern of the marketplace becomes the yield on the guaranteed SBIC debentures.

In terms of deficit reduction, the sale of the SBIC portion of the $150 billion FFB portfolio either with or without recourse to COSBI results in a dollar for dollar deficit reduction. Sale on a full recourse or guaranteed basis of the portfolio would result in substantially higher deficit reduction. A practical question may be to what extent more rather than less deficit reduction through loan sales is an objective. Maximum loan sale proceeds will always be obtained through recourse rather than nonrecourse sales.

In conclusion, Mr. Chairman, we are confident that COSBI works and that it is advantageous to the pricing of COSBI securities to transfer the FFB SBIC portfolio with recourse.

Senator Bumpers. Thank you, Mr. Warner.

Mr. Clare.

Mr. Clare, have you been here before? You look familiar.

Mr. Clare. I have been in the audience before, not to testify.

STATEMENT OF MICHAEL K. CLARE, VICE PRESIDENT OF FINANCE, CITICORP INVESTMENT BANK, ACCOMPANIED BY HENRY D. EDELMAN

Mr. Clare. Mr. Chairman, it is a pleasure to have been invited to participate in these discussions before your distinguished committee.

My name is Michael Clare. I am a vice president at Citicorp Investment Bank, which is part of Citibank, N.A., in New York, and I head our Government finance unit.

With Federal sponsorship, we believe that COSBI is a viable concept and that it will be able to fund its ongoing activities and to borrow enough to purchase the existing $1 billion of SBIC loans, either with or without recourse.

Looking first at the purchase on a with-recourse basis, the existing portfolio of loans has a weighted average interest rate of 11.25 percent. Under current market conditions, we believe that COSBI could fund itself at rates below that 11.25 percent, giving rise to a potential stream of future income if the existing obligations are purchased and held to maturity.

The present value of this cumulative income stream could be approximately $160 million, in our opinion.

Provided market conditions allow COSBI to purchase the loans at today's rates, we are of the opinion that COSBI might be able to realize some, but certainly not all, of this gain up front by reselling the loans once they have been acquired.

In our opinion, the reason COSBI would be unable to capture all of the gain has to do with the investor's exposure to default by the SBIC's. Specifically, we do not believe that institutional investors would pay a price much above the face value of the portfolio. This position is based on the investor's exposure to prepayment by the SBA under the provisions of its guarantee at the face value, or par, in the event of default by the underlying SBIC's.

In other words, as long as the Government guarantee only protects the face value of the securities, our guess is that COSBI would be lucky if it could realize an up-front gain of even $50 million if it were to attempt to buy and immediately resell these loans.

We do believe there is a rather painless solution, however. SBA could promise investors that should an SBIC default, it will simply continue all regularly scheduled payments of principal and interest to maturity.

We believe that this approach is in SBA's best interests in that the full value of the portfolio would now have a much higher probability of being fully realized and because it would provide SBA time to either solve the default situation or to collect on its collateral before making good under the guarantee.

Should it be decided for any reason that the loans would be offered on a without-recourse basis, we believe the existing portfolio of loans will have less value to COSBI. At this point in time, and as my distinguished colleague has indicated, it is very difficult to value the portfolio on a without-recourse basis.

Mr. John Warner, at SBA, was kind enough to provide us with a sampling of the default histories of SBIC loans issued each month in 1978. In the best case, we understand that the SBA has thus far experienced a 2-percent default rate with respect to the September 1978 SBIC debentures. However, 78 percent of the loans issued in March of that year have already defaulted.

Of the 12 monthly issues sampled, the average default experience was 23 percent. Clearly, we would need to see and evaluate all available data with respect to defaults before we could attempt to properly value the loans. We have, however, developed a number of assumptions, so we could provide you with some estimates of the portfolio's value on a without-recourse basis.

We would suggest that a price of about $1 billion, or par, might be appropriate for a portfolio with a 2-percent default history. That, again, was the best case we saw in 1978, whereas a portfolio which anticipated a 78-percent default experience ought to be worth no more than about $650 million in today's market.

The average portfolio with a 23-percent default experience to date ought to be worth about $950 million, in our opinion.

Should COSBI come to terms on purchasing the loans on a nonrecourse basis, we feel the committee should be aware that investors are likely to focus their attention on COSBI's unusually high debt-to-equity ratio at some point in time.

As a practical matter, this may mean that the responsible Federal officials should anticipate the need to demonstrate their support for COSBI sooner rather than later.

Further, COSBI might wish to consider improving its liquidity position by selling, pledging, or otherwise disposing of substantial portions of that loan portfolio. In our opinion, it would not be prudent to place any legislative restrictions on COSBI's flexibility to dispose of these assets.

My colleagues and I are at the complete disposal of your staff to share the methodology we have used in determining the various valuations mentioned this morning. Again, thank you for this opportunity. If there are questions, I will try to answer them.

[The prepared statement of Mr. Clare follows:]

TESTIMONY BEFORE COMMITTEE ON SMALL BUSINESS

AUGUST 7, 1986

Mr. Chairman, it is a pleasure to have been invited to participate in these discussions before your distinguished committee. My name is Michael Clare. I am a Vice President at Citicorp Investment Bank, which is part of Citibank, N.A., in New York and I head our Government Finance Unit. We have been involved with the proponents of the COSBI legislation for a number of months and we will be participating in the upcoming sale of SBA-guaranteed debentures which are about to be offered to fund the SBIC industry. Essentially all of the comments that I will make now have been shared with these people from time to time in recent months.

We believe that COSBI is a viable concept. We believe it will be able to fund its ongoing activities in the private market and that it will be able to raise sufficient cash to purchase roughly $1.0 billion of existing SBIC loans currently held by the Federal Financing Bank. Its viability, however, is predicated on its receiving all (or substantially all) of the advantages of Federal sponsorship.

With Federal sponsorship, we believe that COSBI will be able to borrow enough to purchase the existing $1.0 billion of SBIC loans either with or without recourse. Looking first at the purchase on a with recourse basis, the existing portfolio of loans has a weighted average interest rate of 11.25%. Under current market conditions, we believe that COSBI could fund itself at rates below 11.25% -- giving rise to a potential stream of future income existing obligations are purchased and held to maturity -- that is, the difference between COSBI's cost of funds and its income from existing obligations. The present value of this cumulative income stream could approximate $160 million in our opinion. Provided market conditions allow COSBI to purchase the loans at today's rates, we are of the opinion that COSBI might be able to realize some -- but not all -- of this gain up front by reselling the loans once they have been acquired.

In our opinion, the reason COSBI would be unable to capture all of the gain has to do with an investor's exposure to default by the SBIC's. Specifically, we do not believe -- nor would we recommend -- that institutional investors pay a price much above the face value of the portfolio. This position is based on the investor's exposure to prepayment by the SBA under the provisions of its guarantee at the face value (or par) in the event of default by the underlying SBIC's. In other words, as long as the government guarantee only protects the face value of the securities, our guess is that COSBI would be lucky if it could realize an up front gain of even $50 million if it were to attempt to buy and immediately resell these loans. We do believe there is a rather painless solution, however. SBA could promise investors that should an SBIC default, it will simply continue all regularly scheduled payments of principal and interest until maturity. In other words, SBA would irrevocably give up its rights to prepay at par at any time and for any reason.

We believe that this approach is in SBA's best interests in that the full value of the portfolio would now have a much higher probability of being fully realized and because it would provide SBA time to either solve the default situation or to collect on its collateral before it makes good under its guarantee.

Should it be decided for any reason that the loans would be offered on a "without recourse" basis, we believe the existing portfolio of loans will have less value to COSBI. At this point in time, it is very difficult to value this portfolio on a "without recourse" basis.

Mr. John Warner at the SBA was kind enough to provide us with a sampling of the default histories of SBIC loans issued each month in 1978. In the best case, we understand that SBA has thus far experienced a 2% default rate with respect to the September 1978 SBIC debentures. However, 78% of the loans issued in March of that year have already defaulted. Of the 12 monthly issues sampled, the average default experience was about 23%. Clearly, we would need to see and evaluate all available data with respect to defaults before we could properly value these loans. However, working on the assumptions that a problem loan would pay interest on a timely basis for three years prior to default and that 35 cents on the dollar of collateral value would be recovered, we have developed some estimates of the portfolio's value. We would suggest that a price of about $1.0 billion (or par) might be appropriate for a portfolio with a 2% default history, whereas a portfolio which anticipated a 78% default experience ought to be worth no more than $650 million in today's market. The average portfolio with a 23% -- default experience to date ought to be worth about $950 million.

Should COSBI come to terms on purchasing the loans on a non-recourse basis, we believe the Committee should be aware that investors are likely to focus their attention on COSBI's unusually high debt-to-equity ratio at some point in time. As a practical matter, this may mean that the responsible Federal officials should anticipate the need to demonstrate their support for COSBI sooner rather than later. Further, COSBI might wish to consider improving its liquidity position by selling, pledging or otherwise disposing of substantial portions of the loan portfolio. In our opinion, it would not be prudent to place any legislative restrictions on COSBI's flexibility to dispose of these assets.

My colleagues and I are at the complete disposal of your staff to share the methodology we have used in determining the various valuations mentioned this morning. Again, thank you for this opportunity. If there are any questions, I will be pleased to try and answer them.

Senator **Bumpers**. Thank you very much, Mr. Clare.

Let me defer to my colleague from Oklahoma, Senator Boren.

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator **Boren**. Thank you very much, Mr. Chairman, and I apologize that we have a meeting in the Agriculture Committee going on at the same time this morning, and I am going to have to return. I want to thank the members of the panel who have testified thus far. I think that they have raised some very valid points, particularly in regard to the question of recourse or nonrecourse, and the difficulty of evaluating this portfolio if we were to go on a nonrecourse basis.

Mr. Chairman, rather than take further time now, I would like to simply insert my full statement into the record and commend you and Chairman Weicker for making this proposal. I think that it is an innovative one that should enable us to save some money in terms of the Federal budget and, at the same time, establish some increased stability for a program that is very important to the small business community.

I think we are focusing on the right issues: The question of the Treasury backstop, the recourse question, the question of the conditions and terms for purchase, and also the transition to COSBI, how it shall be carried out, and also I think we need to continue to focus on the question of oversight once COSBI is set up, the degree of oversight that SBA will operate, and the level.

I simply will submit my full statement on these subjects into the record, and thank you very much.

[The prepared statement of Senator Boren follows:]

STATEMENT OF

SENATOR DAVID L. BOREN

ON S. 2647

Mr. Chairman:

The relative strength of small business reflects the relative strength of our economy. No one can question the importance of creating a healthy economic environment for small business. To that end the Small Business Investment Companies program (SBIC) has been an unqualified success. Today over 500 SBIC's and MESBIC's (Minority Enterprise), with assets in excess of $2 billion, are actively providing seed capital to help thousands of small, job creating companies grow and prosper.

However, Mr. Chairman, despite this successful record, the SBIC program has reached a critical crossroads. Uncertain funding and restrictive allocations of scarce dollars have made the SBIC financial support process unreliable. Continually changing government policies have worked to create an unstable operating atmosphere which is counterproductive to long-term investing. Perhaps the greatest insult to the successful SBIC program occurred when the Administration proposed its termination. Thus it would seem that the only way to bring stability and predictability to this industry is to privatize the SBIC program. S. 2647, a bill to create the Corporation for Small Business Investment (COSBI), is the means to that end.

COSBI is designed to operate as a privately owned and managed, special purpose financial institution, with the mission of providing a stable flow of long-term capital and an effective environment for the SBIC industry. The Corporation will have the status of a government sponsored enterprise, similar to the Student Loan Marketing Association (Sallie Mae) or the Federal National Mortgage Association (Fannie Mae).

There are several points of the COSBI proposal that must be addressed at this hearing:

1) The Treasury "Backstop" - this provision should say that if COSBI gets into serious financial difficulty, the Federal Government, thru the Treasury Department, may at is discretion, step in to provide support for the agency. It should not be a guaranty by the Federal Government. It should be similar to provisions provided to other federally-sponsored agencies such as Sallie Mae and Fannie Mae.

2) Purchase of the Federal Financing Bank Portfolio - the Administration has suggested selling SBA and other loan assets at 20 cents on the dollar or less. While they create the appearance of short term savings, the government actually ends up losing a significant part of the long-term value of the assets being sold. COSBI should buy the SBIC debentures held by the FFB, on a guaranteed basis, for 100 cents on the dollar, as well as assuming full responsibility for servicing those debentures. Thus, for $1.0 billion in SBIC debentures, COSBI should pay $1.0 billion in cash. The Treasury Department can then invest the $1.0 billion

and earn interest on it, or they can use the funds to reduce the Federal deficit.

3) The Transition to COSBI - It is important that COSBI's authority to finance and regulate SBIC's only go into effect when certain specified events occur. COSBI should become operational when the corporation has raised its capital, elected a permanent Board of Directors and given notice to SBA that it is ready to conduct business. Only after those transition actions have been taken will SBA's financial and regulatory authority no longer apply to SBIC's that qualify to do business with COSBI.

4) Oversight of COSBI and the SBIC Industry - SBA should have some review authority but only at the COSBI level and not at the level of individual SBIC's. SBA should be authorized to review COSBI's criteria for the qualification of SBICs and COSBI's rules governing the operation of SBICs. In addition, SBA should be authorized to examine COSBI's books and records, to obtain any necessary information from COSBI, and to report the findings of its reviews to Congress. Consequently, if SBA is doing its job, they will be the first to know of any problems at COSBI and they will be in a position to immediately alert Congress so that corrective action can be taken at once.

Mr. Chairman, S.2647 is a positive step to insure a stable climate for the future development of small business. To be able to provide long-term capital for small business while at the same time saving the Federal Government hundreds of millions of dollars is no small feat. I urge my colleagues to support this important and timely legislation.

Senator **Bumpers**. Thank you, Senator Boren, for coming by to share that with us.

Mr. Warner, you indicate that if the market has to take these, if COSBI has to take this portfolio without recourse, that it is going to increase the rate for borrowers to 25 to 50 basis points.

Mr. **Warner**. Yes.

Senator **Bumpers**. Do you have any particular formula that you use in arriving at that? I think that is a legitimate observation, but I am just curious as to whether or not you went through any kind of formula to reach that figure.

Mr. **Warner**. I had an opportunity to discuss that valuation with our trading floor, and we reviewed the experience with other quasi-Federal agencies at different times during periods of some credit question marks over their securities and their portfolios; and, therefore, based on past market experience and our judgment of the market for this new security, we felt that 25 to 50 basis points was our best guesstimate of what that cost would be for a quasi-Federal agency which had a portfolio of a clearly uncertain value, and also one, of course, which completely lacked any liquidity in the secondary market.

In other words, that portfolio, those debentures, in our judgment, could not be sold at any reasonable level just as is.

Senator **Bumpers**. Is that your belief, then, because this is certainly going to be debated on the floor. OMB is going to be insisting that we sell them without recourse. Some, I'm not sure—maybe myself included—will be arguing that it is foolish to do that; that the Government is going to take a beating if it does that, and it is bad economic policy to sell them without recourse because of the situation you described.

If you had a choice—let me put it this way: If the financial markets on Wall Street have a choice, what would they prefer, and why?

Mr. **Warner**. Well, Mr. Chairman, talking about loan sales generally, as I have testified before, there are tens of billions of dollars of loans which are sufficiently high credit quality, that they can be structured and, when structured, rated, and, when rated, sold at very substantial and reasonable proceeds.

Specifically, with respect to the SBIC debentures, I think our knowledge of the underlying data and credit history is imperfect, but, based upon what I have heard my colleague, Mr. Clare, indicate from that 1978 sampling, our judgment would be that if the SBIC debentures have, in fact, a 23-percent default rate, as was mentioned earlier, then it would not be possible to structure them so as to get a rating.

If it is not possible to get a rating, and you know there is a substantial default rate, then the only prices which can be obtained in the marketplace will be subjunk or fire-sale prices. Nonrecourse sales of SBIC debentures, if those debentures are characterized by a 23-percent default rate, would not be sold through Wall Street because we cannot identify who the prospective purchasers would be.

So, Mr. Chairman, we do not see it as an option with respect to the SBIC debentures to sell with or without recourse. The only way, in our view, that they could be sold at any reasonable level and to identifiable purchasers would be with recourse.

Senator BUMPERS. Mr. Clare——

Mr. CLARE. I would agree with that.

Senator BUMPERS. Yes—and in your testimony a moment ago I understood you to say that if we could formulate a sale or design a sale to COSBI of the good part of the portfolio that has demonstrated that it is current, and so on, then, of course, the objection that Mr. Warner has just pointed out would be alleviated, or maybe removed.

Is that a fair statement?

What if we identified all the problem lines, or just lines that had not been right up to snuff, and we only sold COSBI the 77 percent that have a very good credit rating?

Mr. CLARE. That would certainly give me more comfort.

The approach that we might recommend to COSBI might be a little different than Mr. Warner's approach. We might suggest that we attempt to identify a default rate and eliminate those from what is sold to COSBI, or sell the entire portfolio, but reflect in the price that is paid some default expectation, and then, rather than sell those securities or debentures into the marketplace, have COSBI issue its own securities into the marketplace with Federal sponsorship.

As we indicated earlier, we think that this could give rise to the need for the responsible Federal officials to be prepared to step in and demonstrate their support for COSBI sooner rather than later, and, as Mr. Warner indicated, that could also translate into a higher interest rate. Whether it is 25 or 50 basis points, I did not discuss it with my colleagues, my traders. That does not sound unreasonable, however, and we concur that on a without-recourse basis COSBI is going to have some troubled times, we anticipate.

Senator BUMPERS. Excuse me just a second.

The reason I was consulting you is because this 23-percent default rate came as quite a shock to me. It is not the figure that we have been operating with, and I was just checking with staff to see where we might be at variance, and, Walter, you don't have to be sworn, but would you or somebody from SBA, just describe for me what is SBIC's contention, and what is SBA's contention about what the default rate is on this portfolio?

STATEMENT OF WALTER B. STULTS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. STULTS. I will try to answer the question for you, Senator Bumpers.

A default occurs when an SBIC is not making its timely payments of interest, or it is in regulatory trouble with SBA. At that point, SBA takes over and calls that debenture in default. It may well be that within a period of time that SBIC will come back into a current situation and pay interest. It may be that SBA takes over, liquidates the collateral, liquidates the SBIC. SBA get back 100 cents so SBA losses on SBIC loans have been very small, under 5 percent.

On the other hand, there is a higher default rate; what the Wall Street people are telling you is that the institutions, the pension funds, others who buy these securities, want to get paid 11.2 percent interest every 6 months. They want it current. They don't want to have a GNMA situation, where the homeowner can pay off his 14 percent mortgage and the institution gets paid back just the face amount of that GNMA certificate.

So, I think I am being correct that the dilution in the value comes just from the fact that default comes before maturity. The institutional purchaser counts on having a 10-year piece of paper with a stated return every 6 months. When it goes into default, that situation no longer exists.

Senator BUMPERS. Would it be possible, or feasible, to identify? It does not seem like it would be a big problem, and I know that James Miller—we would probably just have to scrape him off the ceiling if we suggested this—but would it be possible to just identify those that, say, had had a default or delinquency more than once and retain those?

Of course, I personally feel that this loss rate is acceptable for the Government. And while it would cost us—obviously, we are not going to be able to sell those things at face value with a 5-percent loss rate—but I propose to sell these things with recourse.

James Miller says absolutely no; you have got to sell them without recourse. And I personally believe that by selling them with recourse, the Government is going to make a lot of money. I just think we are going to take a beating on them if we sell them without recourse.

I think maybe you men are a little too sanguine about what will happen if we sell this whole portfolio to COSBI.

Do you have any comment on that, either one of you?

Mr. CLARE. I concur that there is a potential for, as we indicated, about $160 million, or about a 15- or 16-percent premium to be realized by somebody if it is properly structured. At this point in time, we believe that the income would accrue to COSBI as those securities mature over time, and the difference between the average interest rate they earn, 11 percent, or 11.2 percent, and the average interest rate at which they fund those loans, which would be much lower.

We do not think, however, that you could sell those with-recourse loans at that same premium in the marketplace because the investor would be exposed to being prepaid at par by SBA if they defaulted, and it just would not take that prepayment risk, except if SBA stood there and said we will not prepay if there is a default; we will just make a regular schedule of payments of principal and interest until maturity.

Then, I think you have a much higher probability of realizing that gain in the sale of the with-recourse assets.

Senator BUMPERS. Well, let me ask you this, Mr. Clare—and, Mr. Warner, I would like to have you comment on it, too—if we sell these things with recourse, with SBA, and we put a prepayment provision in there so that you know that you are going to get your money, and so that you know the people who buy these things are going to get their money, do you think the Government would make money by doing that?

In other words, do you think we would lose less on the sale of this portfolio to COSBI if we did that?

Mr. CLARE. Absolutely.

Mr. **Warner**. I might just comment, of course, that a sale of loan assets for Federal budget deficit purposes is a dollar-for-dollar reduction; so, obviously, to the extent that there is a full recourse sale of existing loan assets to the private sector and the proceeds are substantially greater than if on a nonrecourse basis, then the proceeds to the government will be that much greater and the deficit reduction that much greater. That is clear.

If I could make two or three brief comments, one is that with respect to the default rate, again I don't know what it has been on the SBIC debenture. I am merely reflecting what I had heard from my colleague up here.

Second, as you can see, there is a difference in nomenclature between the way Wall Street looks at things and the way agencies look at things, so that for the agency, the ultimate test of the cost of the program is the collection rate: what it finally costs the agency to have made this loan.

For Wall Street, the whole question is the default rate. Investors will only buy those obligations in which they have every reason to expect the timely payments on due dates, as provided by the loan instruments.

Finally, if the default rate is—not the collection rate—but if the default rate is in the neighborhood of 23 percent, as my fellow panelist has indicated it may be, I think that probably the past is prologue and it would not be possible, again on a nonrecourse basis, to structure the sale of those assets, because, despite the elimination of those loans which were delinquent, or in default, or in collection, or in workout, nonetheless, as I mentioned before, the only way we can hope to receive value on these sales will be if they are rated, and it will be necessary to convince the rating agencies that the historical default experience will not prevail into the future.

And I think that that would be difficult to do.

Senator **Bumpers**. If these were sold with—now, as I understand it—and somebody correct me on this, if this is wrong—I understood that these debentures carry a rate of about 11.25 to 11.50 percent.

Mr. **Warner**. Yes.

Mr. **Clare**. Our guess, based on our computer run we did, was that the weighted average return on the portfolio is 11.253 percent, or something like that.

Senator **Bumpers**. If these were sold with recourse, what do you think they would go at a rating of? A pretty good rating?

Mr. **Clare**. It would be triple A, then.

Senator **Bumpers**. Triple A?

Mr. **Warner**. Well, if they were sold with recourse, they would carry the SBA guarantee. The SBA guarantee represents the full faith and credit of the United States. No rating is required.

Senator **Bumpers**. Some people feel stronger about the government than I do, but——

[Laughter.]

Senator **Bumpers** [continuing]. But at that rate, then, what do you think these would go out in the market for?

Mr. **Warner**. If I could just raise a question which I think my colleague may have raised and I did not address, and that is whether or not the FFB de facto prohibition on redemption carries over in the transfer. In other words, if we are dealing with a 11.5- or

11.25-percent piece of paper which is noncall de facto for life, that has one valuation.

If it is prepayable at sometime prior to maturity, it will have another.

Senator **Bumpers**. I have no idea what the mix is, or whether they are all one kind or another.

Mr. **Clare**. It is my understanding that currently SBA would take the position that if an underlying SBIC defaulted, it would step in and prepay that portion of the underlying pool. And that is something that institutional investors do not like. They would prefer to receive a predictable stream, a regular scheduled stream of principal and interest payments.

Senator **Bumpers**. But that particular difference——

Mr. **Clare**. We would like to see that changed, is what I am saying.

Senator **Bumpers**. OK, but even if it were not changed, you are not talking about a big item there, are you?

Mr. **Clare**. Yes.

Senator **Bumpers**. Are you?

Mr. **Clare**. Yes.

Mr. **Warner**. If, in fact, when we are talking about in the neighborhood of 11 percent fully guaranteed securities and noncall for life, those would certainly be at very substantial premiums.

Mr. **Clare**. We estimate that premium about $160 million, and the premium without that fix that we talked about, we would be lucky, very lucky, if we could even get $40 million or $50 million of a premium.

Senator **Bumpers**. Well, those are interesting numbers you throw around, and edifying to me in a general way, as well as on this particular legislation.

Well, you have both very fine witnesses, and it has been helpful to me, and I know that I speak for the chairman. We thank you very much for taking out of your time in coming down here. Obviously, if we get this bill marked up on the floor, which we will, the fight is going to be over recourse versus nonrecourse, and all of your testimony will be very helpful to us.

Thank you very much.

Mr. **Warner**. Thank you.

Mr. **Clare**. Thank you.

Senator **Bumpers**. Just a moment.

I will insert a statement on the record for Senator Nickles and a statement for Senator Pressler.

[The prepared statements of Senators Nickles and Pressler follow:]

STATEMENT OF SENATOR DON NICKLES
CORPORATION FOR SMALL BUSINESS INVESTMENT
AUGUST 7, 1986

Mr. Chairman:

Let me say that this concept is the innovative approach we need to develop a working partnership between the federal government and the private sector. If we can work out any deficiencies that may exist in the legislation, we certainly have a program worth implementing.

In Oklahoma, we have a desperate need for venture capital for small and innovative firms. As we diversify our industrial base, we will need this assistance to provide the capital for this growth and expansion. Presently, we are concentrated in energy and agriculture. What all the state leaders are saying is that we must look to new areas in addition to this traditional base of economic support.

I compliment the Chairman for holding these hearings and I look forward to working with him to formulate the best possible COSBI program.

STATEMENT OF SENATOR LARRY PRESSLER
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS
HEARING ON S. 2647
THE CORPORATION FOR SMALL BUSINESS INVESTMENT CHARTER ACT
AUGUST 7, 1986

I would like to begin by thanking the Chairman for calling this hearing today. I also want to thank the Chairman and ranking member for their efforts which have resulted in this hearing and will hopefully culminate in the creation of the Corporation for Small Business Investment (COSBI).

The COSBI concept is an innovative and sound way of providing a secure future for Small Business Investment Companies (SBICs) and Minority Enterprise Small Business Investment Companies (MESBICs). Since the SBIC Act was originally signed into law in 1958, SBICs--privately owned companies licensed and funded through the SBA to provide equity capital to small firms--have grown in importance. Today, they play a vital role in contributing to the venture capital pool of this nation.

According to Small Business Administration data, SBICs disbursed more than $221 million in the first six months of 1986. This is up 20 percent from the first half of 1985. More significantly it represents an increase of 9 percent over the same period in 1984 which held the previous record. Not only have these companies increased their loan activities, they have also grown larger and healthier. Private capital committed to the SBIC industry is at an all-time high. Total resources have increased almost 30 percent over the last two years.

So, why is this committee meeting to explore legislation to replace the SBA with COSBI as the source of funding for SBICs and MESBICs? After all, according to the old adage: "If it isn't broke, don't fix it." Unfortunately, Mr. Chairman, I am sure many of the witnesses today will tell us the current system is "broke" and that the Federal government has done little to ensure the success of the industry over the past several years.

There are those who believe SBICs and MESBICs have outgrown the original structure established in 1958. In the past, SBA regulation of the industry and annual appropriations were important to the survival of these companies. Unfortunately, because of recent turmoil in Congress and within the Administration over the future of the SBA, stability and continuity have become real concerns within the industry. Indeed, as with many government programs, the failure on the part of Congress to authorize and appropriate in a timely fashion has resulted in lapses in the guarantee authority for the program.

In addition to the stability COSBI could offer, it is also an important step in furthering the goals of the Consolidated Omnibus Budget Reconciliation Act of 1985. Under the SBA programs title of COBRA, SBIC financing was removed from the Federal Financing Bank and the sale of SBIC debentures in private capital markets was ordered.

COSBI, a privately financed but federally chartered corporation, would initially buy these debentures. While I have not seen any projections of savings, I have no doubt this would result in

SIGNIFICANT REVENUES FOR THE TREASURY WHICH, IN TURN, WOULD HELP IN OUR EFFORTS TO REDUCE THE FEDERAL BUDGET DEFICIT.

DURING THE COURSE OF THIS HEARING, MANY QUESTIONS WILL BE RAISED. ONE OF THE MOST IMPORTANT CONCERNS THE PROVISION OF THE LEGISLATION WHICH PROVIDES THAT THE EXISTING PORTFOLIO OF SBIC DEBENTURES BE SOLD TOGETHER WITH A FULL SBA GUARANTEE. OMB AND CBO INSIST THAT ANY GOVERNMENT OBLIGATIONS SOLD WITH RECOURSE WILL BE SCORED AS ACHIEVING NO BUDGET SAVINGS.

THIS IS EXACTLY THE PROBLEM WE FACED DURING CONSIDERATION OF OUR RECONCILIATION INSTRUCTIONS FOR FY 1987 JUST TWO WEEKS AGO. AT THAT TIME WE VOTED TO RECOMMEND THAT THE LOAN PORTFOLIO OF SBA's 503 CERTIFIED DEVELOPMENT COMPANY PROGRAM BE SOLD WITH RECOURSE. AS EXPECTED, CBO INFORMED THIS COMMITTEE IT HAD ACHIEVED NO BUDGETARY SAVINGS.

HOPEFULLY, TODAY'S HEARING WILL SHED LIGHT ON THIS AND MANY OTHER PROVISIONS CONTAINED IN THIS LEGISLATION. I WANT TO WELCOME ALL OF OUR WITNESSES AND THANK THEM FOR COMING. I LOOK FORWARD TO HEARING FROM THEM.

Senator **Bumpers**. Senator Weicker has submitted a series of questions for this panel. We will submit those to you in writing and request that you submit answers in writing to his questions.

Mr. **Clare**. Fine.

Senator **Bumpers**. Thank you very much, gentlemen.

We stand adjourned until the next call of the chairman.

[Whereupon, at 11:18 a.m., the committee adjourned, to reconvene subject to the call of the Chair.]

APPENDIX

STATEMENT OF

THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Submitted to:	Senate Committee on Small Business
Subject:	S. 2647--The Corporation for Small Business Investment Charter Act
Date:	August 7, 1986

NFIB appreciates this opportunity to submit testimony on S. 2647, the Corporation for Small Business Investment Charter Act.

NFIB has supported the concept of the Corporation for Small Business Investment (COSBI) from the outset, and we are pleased to be able to endorse this legislation. We commend Senator Weicker and the Senate Small Business Committee for their efforts on behalf of COSBI, and we are optimistic that the COSBI Charter Act will become law during this Congress, thereby providing an important new facility for warehousing and secondary market sales of SBIC obligations.

NFIB's support for S. 2647 is predicated on three key elements of the bill: its budgetary consequences, its effect on the government's role in the small business credit marketplace, and its impact on the Small Business Investment Company (SBIC) community. Each of these components will be discussed from our perspective, in addition to the concerns we have about the bill.

The most important legislative issue for the membership of NFIB has been--and remains--the size of the federal budget deficit. Small business owners believe that the deficit should be reduced through spending reductions, with an increase in taxes only as a last resort. This perspective has brought upon us the need for hard decisions about the nature and scope of many federal programs.

Certainly the Small Business Administration itself has been the subject of much debate and deliberation in this regard. Yet while many have looked upon this period of fiscal restraint as increasing the limitations on what government can do to assist small firms, NFIB has viewed this time as presenting unique opportunities for reforming and improving programs aimed at small business development. In short, NFIB feels that the need for deficit reduction and the need for a strong and independent agency to represent small business can be reconciled through reforms at the SBA.

It is with the foregoing in mind that NFIB again devised a reform proposal for the SBA this year (a copy of this is attached). An important part of this proposal is the establishment of a government-sponsored corporation to provide a well-defined and permanent secondary market for the SBICs. As it is currently drafted, this bill would provide for the establishment of such a corporation, which would relieve the government of financing obligations for the SBICs in the near term and do the same for the MESBICs in the long term. Industry estimates indicate that purchase by COSBI of the outstanding SBIC debentures now held by the Federal Financing Bank (FFB) and due to mature in 1988 or thereafter would yield a one-time budgetary savings of $700 million. If COSBI were to become operational in 1987, the Act empowers it to purchase debentures maturing before 1988, which might yield an additional $100 million in savings. These savings, coupled with annual appropriations not made as a consequence of the Act, provide the most important basis for NFIB's support.

NFIB is aware of the controversy surrounding the budgetary "scoring" of savings deriving from enactment of the COSBI proposal. While we recognize the federal liability that would persist if SBIC debentures were sold with recourse in the private marketplace, we feel that recourse is necessary to abet the prompt sale of these obligations and to ensure that their value is not debased needlessly. NFIB reminds critics of this proposal that, in the absence of COSBI, the risk and cost of default for these obligations remains with the government anyway. COSBI would provide a means of reducing the deficit to the extent that SBIC obligations do not default. Congressional Budget Office (CBO) scoring of COSBI savings at $0 makes sense only if one presumes a 100% default rate for SBIC debentures purchased from the Federal Financing Bank (FFB) and sold in the private market. This projection is extremely unlikely to be fulfilled.

NFIB believes that the authorizing committees should negotiate a reasonable scoring level with CBO based on conservative default estimates for the SBIC paper in question. This would allow the COSBI proposal to be used for the purposes of meeting the fiscal year 1987 reconciliation target, as the House Small Business Committee has elected to do. This would also be an important step toward compromise with respect to the Administration's budgetary objectives regarding the SBA.

It is quite clear, however, that the debate over the future of the SBA has never been purely budgetary in nature. Rather, lying at the heart of proposals to eliminate or programmatically emasculate the agency has been the fundamental policy issue of the government's role in the small business credit marketplace. In this matter NFIB has stood between those who feel that the government's current role is appropriate and those who feel that its intervention ought to be eliminated entirely. NFIB believes that a vacuum does exist in the credit market for long-term financing for small firms, and we conclude that the SBA can be useful in assisting private capital providers to fill that vacuum. It is our firm conviction, however, that the government's role in assisting capital flows must be as discreet as possible, with the most appropriate participation being in the form of guarantees or Treasury backstops. Such limited involvement minimizes the harmful effects of government presence in the free market while leveraging scarce budget resources toward the desired end. In this regard, the creation of COSBI would significantly reduce--though not eliminate--government involvement in the provision of capital to small firms through SBICs. NFIB looks with favor on any reform that reduces government intervention without reducing program efficiency; the COSBI proposal promises to meet this criterion. In addition, it may prove possible to reduce further the government's involvement with the program once COSBI has established a track record worthy of greater trust on the part of investors.

Critics of the COSBI concept have frequently--and correctly--noted that the legislation would not fully privatize the SBIC and MESBIC programs. They cite continued oversight powers of the SBA over these companies and the continued financial obligation of the government (especially in the case of MESBICs) as evidence of an ongoing federal role. However, it must at last be conceded that the Administration's effort to eliminate this program (and much of the rest of the SBA) has not been met with congressional enthusiasm. This being the case, it would seem prudent for advocates of limitations on government involvement in the credit markets to take what they can get, viz. a substantially reduced federal role in the SBIC programs. While the Treasury backstop line of credit contained in S. 2647 may be noxious to government intervention purists, its implicit value is nothing compared to the explicit value of annual appropriations and a sizable portfolio of SBIC debentures at the FFB. Thus, while NFIB might agree in principle with the critics of COSBI on this point, practical politics dictate accepting this reform proposal on its own merits.

The final reason NFIB supports S. 2647 is the benefits that would accrue to the SBICs themselves and, through them, to small firms across the nation. For over 25 years the SBICs have been hard at work trying to operate profitably while filling their congressional mandate: to provide a source of long term debt and equity capital for small businesses. The success of their efforts is best recounted by the SBICs and their representatives, but suffice it to note here that the program stands as valuable proof that public-private partnerships can accomplish what public or private initiatives may not be able to do severally. Today over 500 SBICs are in operation, and the National Association of Small Business Investment Companies (NASBIC) tells us that these entities have invested over $5 billion in more than 66,000 small firms since 1958. SBIC-financed firms have growth rates ten times greater than other small firms and produce new tax revenues at a five-fold greater rate. Estimates balancing actual federal outlays for the SBIC program against new revenues generated show a cost-benefit ratio of 1 to 110. Clearly the work of the SBICs should be continued.

In spite of the success of the SBIC and MESBIC programs, their federal funding has not been consistent nor their fate secure. Even during periods of relative budgetary plenty, appropriations for SBIC leverage have run dry. It is well known that during the current budget crisis the SBIC programs (among other SBA credit activities) have been targeted for complete elimination. Thus the need for establishing COSBI has become all the more pressing; without it, funding for the SBICs will not be merely inconsistent, it will be nonexistent.

NFIB supports the establishment of COSBI on the realistic assumption that doing so would provide a permanent framework for the warehousing and sales of SBIC obligations. This is important for two reasons: first, SBICs and MESBICs would be certain of a marketplace for their debentures; second, COSBI would maintain and expand the critical nexus between large institutional investors and individual small businesses. These effects would create a more standardized procedure for the management of SBIC paper and would open up vast opportunities for the securitization of that paper. Rather than warping or thwarting the free market flow of capital, COSBI would provide the economic intelligence and market connection necessary to emancipate capital so that it could flow more easily to small firms. This is clearly in the interest of the SBICs, the investors, and the large number of small firms that desperately need long-term capital.

Lest we be naive about the nature of the federal government's present commitment to the SBICs relative to its future one, let there be no mistake: government involvement will persist; and to the extent it does, a subsidy--explicit or implicit--will also persist. Compare the cost of this subsidy, modest in the near term and virtually without cost thereafter, to the massive subsidies afforded larger businesses through the investment tax credit, to farms through price supports, and to the housing industry through mortgage interest deductions. The implicit value of the Treasury backstop is theoretical and minimal next to the hard subsidies provided these other smaller economic sectors. Given the track record of the SBICs and the evidence of their new revenue generation, the implicit subsidy involved in the COSBI proposal is extremely modest. Arguments against it pale when the success of other, similar government-sponsored corporations (such as those serving the home mortgage industry) is considered.

NFIB's endorsement for COSBI is not without reservations. As suggested earlier, a completely privatized SBIC program would be ideal. Recognizing, however, the limitations--both political and economic--to such a course, we endorse S. 2647 in its present form. An additional concern of NFIB's is that as the government's involvement is phased down, the mandate of the SBICs should not be diminished. In particular, NFIB is concerned that a broad range of small firms seeking long term capital will be able to obtain it through the SBICs--not just those firms that promise unusual growth or that have very large capital needs. NFIB has found that the vast majority of existing small firms use commercial lenders for their long term capital needs--and still there is excess demand for such capital. SBICs, particularly through the creative use of equity financing, offer another avenue for obtaining this capital. NFIB hopes that COSBI can provide a means for expanding the depth and range of SBIC and MESBIC capital provision.

Ultimately, the success of the COSBI initiative will depend upon the reception that COSBI securities receive in the marketplace. NFIB is optimistic that the COSBI charter as framed in this legislation bodes well for the creation of a stable and workable intermediary for the SBIC industry. We look forward to supporting S. 2647 as it works its way through the process.

QUESTIONS AND ANSWERS FOR MR. WARNER

1. Does the creation of yet another government sponsored enterprise mean that everyone else will be that much more squeezed out of the credit markets?

1. COSBI, by reason of its credit, will have access to the capital markets. No credit worthy borrowers are being squeezed out of the market. The market is also accomodating a substantial volume of non-rated high yielding taxable debt of corporate borrowers.

2. How would Wall Street go about evaluating the value of the SBIC portfolio if sold on a non-recourse basis?

2. Wall Street is in no position to currently evaluate a nonrecourse SBIC debenture portfolio in the absence of detailed statistics concerning the portfolio, particularly concerning the default rate.

3. Is OMB correct when it claims that the markets value the risk that the government is gratuitously assuming in guaranteeing the SBIC portfolio as the difference between what the portfolio would sell for with and without recourse?

3. No. Risk as defined by ultimate collection loss will be different in SBA hands than if SBIC debentures were sold nonrecourse to third party holders. Because of agency forebearance, I imagine that the collection loss will be lower with SBA recourse, and hence the availability of agency forebearance and workout.

4. What circumstances would lead to the trigger of the backstop? Do you believe that all Federal Agency paper would suffer if the Treasury did not intervene to protect COSBI in the instance of some crisis?

4 The backstop would be triggered, I presume, through losses at COSBI, which could happen through a variety of circumstances including unmatched funding and SBIC debenture defaults (assuming nonrecourse to SBA).

5. What impact on the balance sheet and market presence of COSBI does the purchase and immediate resale of the Government portfolio have?

5. I cannot respond in the absence of a more detailed understanding of this alternative.

CITICORP INVESTMENT BANK

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Michael K. Clare
Vice President

October 30, 1986

Ms. Tracy Crowley
Hearing Clerk
Committee on Small Business
United States Senate
Room 428A Russell Senate Office Building
Washington, D.C.

Dear Ms. Crowley:

The following is Citicorp Investment Bank's response to questions forwarded to me by Chairman Weicker on August 12, 1986 following my testimony before the Senate Small Business Committee, on August 7, 1986 regarding the bill S.2647.

1) Does the creation of yet another government sponsored enterprise mean that everyone else will be that much more squeezed out of the credit markets?

- As of February 1986 Federally-sponsored Agencies had about $254 billion in debt outstanding. In addition, as of 12/31/86 there was a further $213 billion of mortgage pools guaranteed by Ginnie Mae and $5.5 billion of Title XI issues guaranteed by the Maritime Administration outstanding. Consequently new issuances of $210 million per year, which is what is anticipated for COSBI, would have essentially no impact on either the availability or cost of credit to existing government sponsored agencies.

2) How would Wall Street go about evaluating the value of the SBIC portfolio if sold on a non-recourse basis?

- The process of determining the value of the SBIC portfolio is a complex one involving the analysis of a number of variables including
    - the absolute levels of interest rates compared to the yield of the portfolio
    - the default history of the portfolio including the timing of defaults i.e. do they tend to occur early or late in the life of the security;
    - the expectation as to recoveries on defaulted loans; and
    - any restrictions which COSBI might impose on the resale (or secondary markets) for these assets;

We have reviewed these factors in detail with the Senate staff.

3) Is OMB correct when it claims that the markets value the risk that the government is gratuitously assuming in guaranteeing the SBIC portfolio as the difference between what the portfolio would call for with and without recourse?

- Such an assertion would seem to be somewhat axiomatic. Perhaps the more relevant question is would the market accurately and efficiently value the portfolio if it were sold with recourse as opposed to without recourse. This question is subject to much debate, but, it is our guess that the market is not completely efficient and hence there might well be a difference between the risk the government is currently assuming and the valuations which the market might give to portfolios sold with and without recourse. For instance, if there were a government guarantee and if the yield on the portfolio is far greater than current interest rate levels, the market would have to pay a substantial premium over par in order to value the portfolio accurately. However, as a general rule, there is reluctance on the part of investors to pay a premium over par and since the government's guarantee would most likely only cover the par value in the event of default, investors who bought at above par prices would subject themselves to considerable losses in the event of default.

4) What circumstances would lead to the trigger of the backstop? Do you believe that all Federal Agency paper would suffer if the Treasury did not intervent to protect COSBI in the instance of some crisis?

The triggering of the use of a backstop facility could occur if the losses on the COSBI portfolio exceeded expectations and hence threatened COSBI's ability to service the debentures which it had issued to buy the portfolio. Should Treasury not intervene to protect COSBI during a crisis, investors could be far less trusting of the quality of their investments in Federally-sponsored Agencies. This would tend to drive up interest rates for such Agencies.

5) What impact on the balance sheet and market presence of COSBI does the purchase and immediate resale of the Government Portfolio have?

- It is anticipated that the purchase and sale would have little effect since both would take place close to par.

If you have any further questions, please do not hesitate to contact me as (212) 668-3687.

Very truly yours,

Michael K Clare